

## Research Article

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# Deconstruction and Reconstruction of the “Comply or Explain” Principle in EU Capital Markets

**Abstract:** The “comply or explain” principle has already acquired significant importance in corporate law and regulations and is considered to be the preferred regulatory tool in the EU for increasing transparency and disclosure of market participants’ strategies and activities. The flexibility of the principle is perceived as the most suitable way to create indirect coordination of practices amongst market actors, as well as better mutual understanding of their different priorities. Having initially shown its considerable appeal in the area of corporate governance statements issued by corporate entities, it has now expanded its influence into other areas serving similar transparency imperatives, such as the exercise of stewardship responsibilities by institutional investors and proxy advisors. In this paper, we will focus on the merits and shortfalls of the “comply or explain” principle in all the above-mentioned areas, both at national and at EU levels, and will critically challenge its effectiveness in the current regulatory framework. Moreover, we will seek to justify its continued use by demonstrating its future potential role as a veritable dialogue spectrum between different market participants. Lastly, we will emphasise the need for a soft monitoring process from national regulators which will enable both the “comply or explain” principle and its users to participate in a holistic effort for the adoption of sound investment strategies via the fruitful exchange of views and ideas and better communication with regard to their respective role in capital markets.

**Keywords:** “comply or explain”, principle, capital markets, listed companies, compliance, institutional investors, proxy advisors, disclosure

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#### Thematic Issue on 'The Comply or Explain Principle: Fair or Foul?'

Fair is foul, and foul is fair  
 Hover through the fog and filthy air  
 Shakespeare, Macbeth [Act 1.1.11–12]

- 1 Sergakis, Konstantinos (2015) 'Deconstruction and Reconstruction of the "Comply or Explain" Principle in EU Capital Markets', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2014-0007.
- 2 Duhamel, Jean-Christophe (2015) 'The "Comply or Explain" Approach as a Pascalian Wager', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2014-0021.
- 3 Biondi, Yuri (2015) 'An Economic Analysis of 'Comply or Explain Principle' under a Review Panel Regime', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2014-0025.
- 4 Sergakis, Konstantinos (2015) 'A Rejoinder on Mr. Duhamel's Commentary', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2014-0024.

## 1 Introduction

The financialisation of companies, economies and societies at large is an unquestioned fact which has shaped, nurtured and influenced a distorted view of the purpose of doing business and the expectations that market participants can have from companies and their investment in capital markets. The ever-increasing focus on short-term profits for all parties involved in the investment chain, their disconnection

from companies’ identity and goals, as well as the overall ramifications of business practices on stakeholders have destabilised the foundations of modern capitalism. The 2007–2008 global financial crisis triggered, in a blatant way, the need for sounder investment strategies and better communication between market actors. Although the link between these two concepts is not necessarily straightforward, we believe that it is more likely for long-term and sustainable investment strategies to arise from an adequate communication framework between market participants. A dialogue that includes a broader series of market participants will be able to lead to beneficial outcomes for the whole investment community, driving the debate beyond short-term incentives and strategies, and taking into account a broader series of incentives and considerations. Mutual understanding and fruitful interaction between various market participants has emerged as one of the imperatives of twenty-first century regulatory trends due to the ever-increasing communication gap and lack of engagement between companies, financial intermediaries and investors.

On the one hand, short-term investment strategies focused solely on share price return, instead of taking into account the continuity of companies and their potential to contribute to economic growth, have shown the problematic aspects of a narrow and speculative conception of capital markets that tends to be dissociated from investee companies and their own existence in national economies. This investment trend finds its roots in the “shareholder primacy” theory that conceives of companies purely as profit-making organisations for the exclusive benefit of their shareholders, while neglecting them as holistic entities with a series of broader consequences on other parties affected by their activities, such as suppliers, customers and other stakeholders.<sup>1</sup>

On many occasions, corporate boards have been subject to short-term pressures from institutional investors and, as will be explained later in this paper, tend to align their strategies with the investment agendas of various groups in order to raise capital and remain attractive on capital markets, which have historically functioned under the efficient market hypothesis

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<sup>1</sup> For a very interesting deconstruction of the shareholder primacy model and the defence of the firm as an enterprise entity with a wider conceptual framework, see Biondi (2013, p. 397).

<sup>2</sup> The debate continues on the existence of empirical proof of the benefits of shareholder engagement. The empirical studies conducted in the past are not conclusive as to whether shareholder activism is crucial to improving companies’ performance or simply irrelevant. Regardless of the negative or positive effect of this kind of activism, it could be said that in theory it is always better to have a certain amount of indirect pressure from asset managers or asset owners of the shares, which will possibly alert the company’s management and avert certain deficiencies in conducting business: Gillan and Starks (2007); Demiralp, D’Mello, Schlingemann, and Subramaniam (2011); Romano (2001).

(Fama, 1970) and the “shareholder primacy” doctrine. Although some investor groups have shown willingness to engage with boards effectively,<sup>2</sup> others have damaged the stability of companies and the market in general since they only invest with short-term return objectives and the achievement of specific goals, which are clearly not compatible with the sustainable existence of a company and do not involve any element of communication (Heineman, 2010).

On the other hand, the interaction between boards and institutional investors in this context is not clear since the predominance of institutional investment has not always been associated with effective engagement with boards and fruitful discussion of the future of the company. The quasi-automatic alternation and diversification of portfolio investments might seem to be a preferable investment strategy because it saves investors from being engaged in lengthy and time-consuming discussions with companies. What is even worse, institutional investor apathy makes the communication factor even more problematic for future regulatory agendas since investors tend to prefer the above-mentioned portfolio diversification in order to mitigate market risk, therefore becoming reluctant to invest time and resources to engage with every single investee company.<sup>3</sup>

The problems mentioned above and related to a lack of engagement and inappropriate short-term strategies can be eventually overcome by the development of a disclosure trend covering a vast area of market actors and inviting them, in a flexible regulatory framework, to make visible their practices and conception of their role in capital markets. Therefore, the adoption of soft law measures, allowing different parties to disclose their strategies and activities, has traditionally been considered the preferred regulatory tool that has genuine potential to bring together different kinds of information, resulting gradually but steadily in indirect coordination between various market practices and mutual understanding of their respective needs. It is thus believed that out of a flexible disclosure spectrum, market actors will have the chance to evaluate and interact with each other in a productive way with the ultimate goal of actively participating in a fruitful exchange of views on the future of capital markets, while contributing to a much more sustainable investment model. This kind of interaction is considered to be the only possible way to build a long-term vision of a prosperous investment landscape, although such a system has

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<sup>3</sup> The UK government, following a call for evidence “A long-term focus for corporate Britain” published in October 2010, asked Professor Kay in 2011 to launch a report examining to what extent equity markets are achieving their core purposes. After a respective call for evidence and an Interim Report, the Final Report entitled “The Kay Review of UK Equity Markets and Long-Term Decision Making” [hereinafter the Kay Report] was published in July 2012, with a very interesting analysis on shareholder engagement and problems associated with the increase of financial intermediation <http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf> accessed 10 May 2014.

not yet proven to be the preferred one.<sup>4</sup> The reasons for such scepticism lie within the inherent deficiencies of mandatory disclosure which, while trying to serve highly praised goals such as reduction of informational asymmetry and increased awareness amongst market actors, might become counter-productive and burdensome.<sup>5</sup> Also, generally debating the merits of disclosure, we must bear in mind that the information itself might be instrumentalised by its provider when it is purely conceived as a “window-dressing” exercise and not as genuine exposure and willingness to make market participants more sophisticated and better informed.

The debate around the benefits of disclosure becomes even more complicated if we consider that the information will probably be instrumentalised not only by its provider but also by some of its users wishing to exploit it for purely speculative purposes when participating in capital markets. Indeed, one of the main arguments against more disclosure focuses on the danger of speculation and increased short-termism which would motivate market participants to adopt a purely myopic view of the company as a necessary means for continuing with their speculative practices. It goes without saying that confidentiality as well as corporate technologies and “know-how” should be carefully protected given the substantial risk of compromising an innovative business project, and potentially causing it to fail, if the company is required to disclose relevant information to the market, and inevitably to its competitors, under the applicable regulatory framework. Whatever the overall conclusion on the merits and deficiencies of disclosure, we believe that disclosure has a role to play, for better or worse, not just for companies but also for other market participants.

Moreover, it is rather preoccupying that “window dressing” and speculative practices continue to be used by, respectively, the providers and the recipients of information disclosed under soft law frameworks. These phenomena may also lead us to question not only the ability of soft law to shape and influence parties’ behaviour but, most importantly, its biased connection with the financialisation of companies, economies and societies at large and its instrumentalisation for the continued use of short-term and speculative practices. Therefore, the regulatory agenda needs to channel its efforts to create a disclosure spectrum that can bridge the gap between the providers of information, aiming to maintain flexibility, and the recipients of information, aiming to evaluate the providers, without allowing either party to abuse either the framework in which disclosure obligations operate or their content.

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<sup>4</sup> For a more general analysis on the correlation between regulatory reforms that aim to increase shareholders’ rights and the actual improvement in shareholder activism, which does not always seem so obvious, see Mendoza, Van der Elst, and Vermeulen (2010, pp. 29–34).

<sup>5</sup> See the very interesting analysis of Enriques and Gilotta (2014).

The UK, in an attempt to adopt a widely applicable soft law tool, became the precursor in regulatory rulemaking with the introduction of the “comply or explain” principle in the area of corporate governance codes in 1992,<sup>6</sup> whereby companies are required to comply with the provisions of the UK Corporate Governance Code or to explain the reasons they have decided not to do so. Since its initial adoption, the “comply or explain” principle has been at the centre of attention in corporate governance-related matters and continues to be one of the most debated issues with regard to its usefulness, effectiveness and influence on corporations. Having proven to be a very popular regulatory tool, for reasons which will be explained later in this paper, it has since been adopted at the EU level with Directive 2006/46/EC,<sup>7</sup> for corporate governance statements. Most importantly, the European Commission and various national regulators and industry committees, tasked with issuing best practices for their sector, continue to emphasise the suitability of this principle and therefore keep relying on its merits in order to proliferate and further legitimise soft law rulemaking.

Nevertheless, the “comply or explain” principle has already shown a series of deficiencies that continue to dent its attractiveness and its persuasiveness as the preferred regulatory tool in capital markets. These deficiencies are mainly due to market actors’ rather superficial conception and use of the principle, in the case of both those who are supposed to disclose their practices according to the principle and those who are supposed to benefit from such disclosure. These concerns combine with a considerable amount of criticism regarding the principle’s laxity for its users and the lack of enforcement in cases of non-respect. These arguments have led the debate towards the reconsideration of soft law measures as the most suitable regulatory means for ensuring companies’ adequate compliance with a certain set of rules. Indeed, would soft law still be the appropriate solution for tackling issues related to deviation from generally accepted corporate governance practices? And, most importantly, is soft law in general able to influence market participants’ behaviour and guide them towards long-term and balanced corporate governance?

This article will therefore endeavour to analyse the success as well as the shortfalls of this principle, while providing a novel approach not only to its conception by regulators and market actors but also to its future role in capital markets, which will allow all parties involved to benefit to a greater extent from

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<sup>6</sup> Sir Cadbury (1992).

<sup>7</sup> Directive 2006/46/EC of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings [2006] OJ L224/7.

its use. Section 2 will give an overview of the expansion of the principle into different fields in the broad area of corporate finance and will attempt to discern the reason for this trend towards propagation of the principle in regulatory methods. Section 3 will “deconstruct” the principle, providing a thorough review and a critical analysis of its main components and the challenges currently facing its success. Section 4 will propose a “reconstruction” of the principle based on a series of proposals aimed at strengthening its components and justifying its continued use in the future regulatory agenda. Section 5 will draw conclusions from these proposals and reflect upon prospective regulatory policies.

## 2 The proliferation of the “comply or explain” principle

### 2.1 Listed companies’ statements

Companies must adopt a corporate governance system that is not solely focused on profit maximisation and share price return, but goes beyond these goals and strives to achieve investment innovation, growth and economic performance. It is in this perspective that companies will not only ensure their success and remain attractive to other market participants<sup>8</sup> but also continue to play a key role in national economies. In an attempt to make corporate governance mechanisms much more visible, via disclosure obligations expressed in corporate governance statements, regulators found the “comply or explain” principle to be the ideal combination of disclosure and adaptability. On the one hand, disclosure as a principle is a theoretical catalyst for more informed and sophisticated decisions by investors, based on the information that companies provide regarding their corporate governance system. On the other hand, adaptability is a key issue with corporate governance statements, taking into account that companies’ structures vary widely both nationally and internationally.

The most important EU initiative on the corporate governance landscape was the adoption of the “comply or explain” principle through Directive 2006/46/EC, as previously mentioned. The EU fully endorsed the principle by inserting a new Article 46a into the 4th Company Law directive.<sup>9</sup> Companies whose securities are admitted

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<sup>8</sup> Shleifer and Vishny (1997); see also, for one relatively recent empirical study, amongst many in this area, Renders, Gaeremynck, and Sercu (2010).

<sup>9</sup> Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies [1978] OJ L222/11.

to trading on a regulated market must include corporate governance statements in their annual reports. In turn, these statements must include information with regard to either the corporate governance code that the company has decided to abide by or the code that the company applies or any other information regarding corporate governance practices that go beyond the requirements of the national framework. Moreover, in cases in which a company decides to depart from a corporate governance code, fully or partially, it must give explanations on the reasons for such a decision. In the case of partial non-compliance, the company must clarify further which respective sections of the code are not followed.

More recently, Directive 2013/30/EU requires listed companies to disclose information with regard to certain corporate governance arrangements in their corporate governance statements following the “comply or explain” principle, according to the same framework provided by Directive 2006/46/EC.<sup>10</sup>

The “comply or explain” framework is extremely flexible and although it has not caused corporate governance strategies to converge, precisely because – quite wisely so – such a goal was never included in the EU or national regulatory agendas, it has nevertheless met with considerable popularity amongst regulators and market participants since it provides a commonly acceptable framework for the emergence of various disclosure trends and information that are not hampered in their originality and usefulness by the well-known rigidity of a hard law framework, identified with a stringent “one-size-fits-all” approach that would seem unrealistic in corporate governance (Kraakman et al., 2004). By knowing in advance that the principle allows a corporate entity either to comply with soft law rules or to deviate and explain the reasons for its “non-compliance”, a company has a much more convincing incentive – at least in theory – to be substantially more open regarding its corporate governance system. This in turn allows the recipients of this information to understand in a preferred way the company’s strategies and to evaluate it in a more informed and sophisticated way. The particular attachment to increased investor awareness and sophistication when it comes to evaluating the investee company is nothing new.

The ongoing expansion of disclosure trends for the benefit of investors at large can be undoubtedly explained by the revival of ownership theories in listed companies (Biondi, 2012) and, more specifically, the “shareholder primacy” model in corporate governance which, after having confronted and successfully dominated the “stakeholder theory” and “enlightened shareholder value” (Keay, 2012; See also Keay, 2009), focuses corporate managers’ attention exclusively on profit

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**10** Article 20(1) of Directive 2013/34/EU of the European Parliament and the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC [2013] OJ L182/19.



maximisation for the benefit of shareholders.<sup>11</sup> Nowadays, the primary purpose of publicly traded companies continues to be profit-oriented for the benefit of shareholders,<sup>12</sup> even if, as previously mentioned, listed companies should not only strive to maximise profit for shareholders but also contribute to economic growth and innovation, thus serving a multifunctional conceptual framework (Stout, 2013, p. 65).

Therefore, the centre of regulatory attention is inevitably channelled towards the formation and expansion of a holistic disclosure trend, whose list of recipients continues to include various market actors who interact with shareholders and are involved, directly or indirectly, in investment decisions (Enriques & Gilotta, 2014, pp. 4–7). It is thus expected that out of various disclosure statements, investors will be better protected or, at least, feel much more immune against inappropriate practices, developed either from corporate management or financial intermediaries with whom they continue to interact on capital markets.

It was therefore no surprise that the “comply or explain” principle was broadly accepted with regard to corporate governance statements and has confirmed its status as one of the most important regulatory tools in an increasingly diverse corporate landscape. By refocusing the debate on “shareholder primacy” in order to convey the message at the EU and international level that shareholders count, are efficiently protected and therefore securing their “confidence” to invest on a constant basis, the current regulatory agenda further strengthens their powers by acknowledging that they have rights to exercise and financial intermediaries have, in their respect, responsibilities to assume. The epitome of this “shareholder” regulatory focus is expressed *via* the assurance that all financial intermediaries associated with shareholders need to be part of this disclosure trend and make visible their practices as well as their overall methodologies.

Having become the “regulatory safety net” and the guarantee for the same flexibility for all market actors involved in the investment chain, the “comply or explain” principle keeps on being extensively used with regard to the exercise of stewardship responsibilities by institutional investors to their clients, i.e. the ultimate beneficiaries of the investment process.

## 2.2 Institutional investors’ statements

Institutional investors have recently come under the regulatory spotlight due to their stewardship responsibilities, namely the duties bestowed upon the executive

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<sup>11</sup> See for example Berle (1932) and, for the revival of the “shareholder primacy” model in the 70s, Jensen and Meckling (1976).

<sup>12</sup> For a series of very convincing arguments against the “shareholder primacy” theory, see Stout (2012a). See also Stout (2012b).

management of the investor group as well as on the asset managers in charge of monitoring and developing their portfolios. According to one definition,

stewardship is responsible and thoughtful ownership. It is synonymous with an ownership mindset and adopts a long-term perspective, but with a focus on value creation [...] It is also a mechanism to ensure the appropriate use of the power vested in institutions to properly and effectively manage the funds, such as savings and pension contributions, entrusted to them by the ultimate investors, the beneficiaries. (Foundation for Governance Research and Education, 2011, p. 12)

There is no doubt that this stewardship trend is closely associated with the revival of ownership views and, more generally, the “shareholder primacy” theory, as explained above (Biondi, 2012, p. 4). Financial intermediaries are invited to show at which point they can become good stewards on behalf of shareholders in order to convey the message to the market at large that the centre of attention remains the ultimate beneficiaries, who are therefore encouraged to continue to invest in capital markets. Stewardship, if effectively implemented, therefore works as an additional guarantee (at least in theory) that intermediaries will act in the best interests of their clients and not in their own personal interests. The evolution and expansion of the stewardship movement reminds us of the evolution of agency issues arising from the separation of shareholding from control and management (Berle & Means, 1932), whereby directors had to ensure shareholders that they were acting in their best interests instead of abusing their power and becoming entangled in agency problems. It is therefore very interesting to see the evolution of this parallel conceptual tendency for intermediaries to be encouraged to show the market that they manage their clients’ assets effectively exactly because it is of vital importance for the latter to maintain their confidence both in company directors and in financial intermediaries with which their investment is entrusted.

The EU has not yet officially adopted any measures on stewardship although this issue is included in its policy agenda. While not the only EU Member State to have dealt with this issue,<sup>13</sup> the UK moved towards adopting the UK Stewardship Code in 2010. This Code contains a series of provisions to be used by institutional investors. To date, it represents the most sophisticated approach in Europe.<sup>14</sup>

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<sup>13</sup> See, for example, the Dutch best practices for engaged shareholding: [http://www.eumedion.nl/en/public/knowledgenetwork/best-practices/best\\_practices-engaged-share-ownership.pdf](http://www.eumedion.nl/en/public/knowledgenetwork/best-practices/best_practices-engaged-share-ownership.pdf) accessed 15 March 2014.

<sup>14</sup> After a consultation period, the UK Stewardship Code was revised in September 2012 and took effect on 1 October 2012: FRC (2012a). For an analysis of the Code, see Reisberg (2011). See also Chiu (2012).

Without analysing in-depth all the implications emerging from the principles of the UK Stewardship Code, it would be useful to mention that institutional investors are expected to disclose information on a series of issues, such as their policies on how they discharge their responsibilities towards their clients, how they manage potential conflicts of interest in the exercise of their duties, how they monitor investee companies, how they exercise their voting powers and, finally, they are expected to report periodically, or at least annually, to their clients on their stewardship activities. The revised version of the Code further developed a series of important issues for its recipients.<sup>15</sup>

It has set a target of increasing awareness of investment-related problematic issues and is attempting to change the current short-term mentality in the market<sup>16</sup> in an extremely flexible way since, contrary to national corporate governance codes as previously mentioned, institutional investors are not

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**15** The major contribution of the revised version is the enrichment of the guidance notes, as well as an introductory section aimed at clarifying the notion of stewardship and the use of the “comply or explain” principle in this context.

With regard to stewardship, a problematic area of the Code was – in its initial version – the fact that it was not clarified in a way that would allow full understanding of the range of responsibilities for all stakeholders. The Code now indicates that

[f]or investors, stewardship is more than just voting. Activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings. (Stewardship Code, 2012, p. 4)

Moreover, the initial text was not very detailed in terms of other market participants potentially involved in the investment procedure and thus subject to the same stewardship responsibilities. The phrasing of the initial version of the Code thus left room for improvement, and the current revision of the Code seeks to satisfy this necessity by mentioning that “[t]he Code is directed in the first instance to institutional investors, by which is meant asset owners and asset managers with equity holdings in UK listed companies [...] Accordingly, the Code also applies, by extension, to service providers, such as proxy advisors and investment consultants”: (2012, p. 5).

Additionally, the duty to act in the client’s interests is not solely conceived with regard to engagement and voting – which were mentioned in the initial version of the Code – but it is generally required by institutional investors, enlarging the scope and application of this duty: (2012, p. 6). Last but not least, the new version of the Code requires not just putting in place and maintaining but also publicly disclosing the institutional investor’s policy for contending with and managing all possible conflicts of interests: (2012, p. 6).

**16** The short-term strategies and preferences have reached an alarming point where managers had declared that they were willing to sacrifice the company’s prospective value in order to satisfy those pressures from their clients (and their own remuneration schemes): Graham, Harvey, and Rajgopal (2006).

required to follow the Code but are simply encouraged to become its signatories and under that assumption are expected to disclose compliance with, or deviation from, its recommendations. The reason for this increased flexibility in this area is undoubtedly regulators' desire to avoid, at least for the time being, counter-productive intervention in the area of institutional shareholders. By allowing a disclosure trend to emerge gradually *via* the encouragement of signing up the Code, it is expected that the increasing number of signatories will participate in this trend, thus allowing the rest of the market to understand the exercise of their activities. Although such an invitation might seem quite superficial, looking back in 2010 when the Code was first introduced, we have to consider it was the only possible regulatory approach that allowed, at that time, this disclosure trend to expand to other countries and which prepared the field for the European regulatory response that came recently with the proposal for a Directive aimed at encouraging long-term shareholder engagement (this will be discussed later in this paper).<sup>17</sup>

Therefore, the main objective of this stewardship trend is to give visibility and awareness of the need for a viable, constant dialogue between company management and institutional investors, which will hopefully generate a realistic alignment of their respective incentives and targets. Even though critics of the "shareholder democracy" and profit maximisation theory have wisely asserted that the alignment of shareholders' and corporate boards' interests was already expressed in short-term strategies (Aglietta & Reberioux, 2005), the stewardship trend claims, at least in theory, the usefulness of a much more engaged dialogue which, by making shareholders much more aware of the complexities of the whole investment chain, will allow a realignment of different agendas not focused solely on short-term goals.

In fact, the Code refers to the concept of stewardship as something that "aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper" (Stewardship Code, 2012a, p. 4). Stewardship thus encompasses various activities for different actors involved in the investment chain and invited by this regulatory tool, following the "comply or explain" principle, to adhere to certain standards or to justify their non-compliance.

Acknowledging, as in the case of company profiles, that institutional investors have inevitably different strategies, conceptions and focuses with regard to

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<sup>17</sup> Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, Brussels, 9 April 2014, COM(2014) 213 final, 2014/0121 (COD) <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014PC0213&from=EN> accessed 15 May 2014.

the exercise of their business activities, the “comply or explain” principle once again found itself at the centre of attention and was considered to be the only realistic tool to give the necessary flexibility to an ever-growing number of financial intermediaries to disclose information on their activities. Again, it is expected that out of this kind of flexible disclosure framework, their clients will be in a position to evaluate them better and to make informed decisions when choosing the investor group that will manage their capital.

Therefore, it comes as a plausible assumption that regulation continues to rely on the “comply or explain” principle to make various activities much more visible and subject to interaction and informed dialogue amongst market participants, with the long-term objective of finding a common point of reference and alignment between different objectives. Notwithstanding this regulatory framework’s “idealistic” purpose, which does not seem to fit perfectly with the prevailing short-term mentality of institutional investors (Villiers, 2010, p. 287; see also Ambachtsheer, Fuller, & Hindocha, 2013), encouraging market actors to interact, via the disclosure of their practices, might be a first step at the EU level to refocusing the debate on the necessity for “genuine” shareholder engagement, namely an engagement that does not focus solely on short-term strategies and shows a less myopic conception of the company’s long-term existence and continuity.

This view is not exempt from criticism and, more specifically, from the fact that interaction between market participants may arguably be only the *consequence* of long-term behaviour, not its *cause*. Indeed, it is difficult to assume that because various parties have a flexible framework whereby they can interact and evaluate one another, they will necessarily develop a constructive dialogue and adopt collectively long-term objectives. Nevertheless, following this line of interpretation, we risk relying upon the eventual scenario that participants that are already long-term oriented will develop such a dialogue on their own. This will marginalise all the beneficial outcomes that might result from educational purposes and the ongoing incentives to build dialogue between participants, acknowledging the different priorities of all parties involved but still building together a conceptual framework towards long-term strategies and objectives. Of course, under this ideological construction, speculative participants will never be part of the dialogue or may participate purely for “window-dressing” purposes since they will still be seeking financial incentives to move towards long-term strategies. But this should not prompt regulatory efforts towards maintaining a distance from various parties and leaving such an important issue exclusively to ad hoc initiatives. Dialogue should be generated in an already educated and sophisticated environment. For the level of education in capital markets to rise and for various parties to understand not only the benefits that they may derive from investment practices but also their own

responsibilities in the entire investment chain, as well as the ramifications of their choices for other participants, the dialogue needs to occur *upstream* and present a convincing case for a long-term vision. If the educational and preventive prerogatives are lost, the communication gap will persist only to be bridged partially and periodically in cases where market participants with considerable power, resources and sophistication are in a position to influence their counterparties with regard to their long-term objectives.

The current EU agenda has included shareholder engagement as one of its distinctive features by conveying the message that this is a topic that must be dealt with at the EU level in the future. Apart from the publication of some recent informal talks with interested parties,<sup>18</sup> the European Commission had expressed its interest in promoting this agenda since the Green Paper on corporate governance in financial institutions and remuneration policies (Commission, 2013b) and the Green Paper on EU corporate governance, which received wide support from its respondents (Commission, 2011a). A much more decisive step was reached with the EC Action Plan in 2012, which further clarified the need for much greater shareholder engagement at the EU level with the announcement of an initiative, possibly through modification of the Shareholder Rights Directive, that would deal with the disclosure of voting and engagement policies, as well as voting records provided by institutional investors (Commission, 2012). The crucial step was finally reached with the proposal for a Directive to encourage long-term shareholder engagement and certain elements of the corporate governance statement (Commission, 2014).

Aiming to increase transparency in financial intermediation, article 3f of the proposal requires Member States to ensure that institutional investors and asset managers will develop an “engagement policy” that will define *grosso modo* the way they will exercise their activities with regard to the integration of shareholder engagement into their strategy, the monitoring of and dialogue with investee companies, the exercise of voting rights, the use of proxy advisory services and cooperation with other shareholders.<sup>19</sup> Most importantly, Section 3 of the same article expects Member States to ensure that this engagement policy includes policies that are purported to manage actual or potential conflicts of interest that may arise in this framework, while providing a non-exhaustive conflict-of-interest list.<sup>20</sup>

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<sup>18</sup> The Commission engaged in informal discussions with stakeholders in early 2013: Commission (2013a).

<sup>19</sup> Ibid. Article 3f § 1, 19.

<sup>20</sup> “Such policies shall in particular be developed for all of the following situations:

(a) the institutional investor or the asset manager, or other companies affiliated to them, offer financial products to or have other commercial relationships with the investee company;

Apart from developing an engagement policy, the proposal expects institutional investors and asset managers to provide annual public disclosure of this policy, the framework of its implementation and the consequent results.<sup>21</sup> More generally, when they decide not to develop an engagement policy or to disclose its implementation and its results, institutional investors and asset managers are expected, following the “comply or explain” principle, to give a clear and reasoned explanation for this choice. The European Commission has justified the use of the “comply or explain” principle in the proposal by advancing the argument, similarly to other occasions in the past, that “Member States should have a degree of flexibility as far as the transparency and information required in this proposal are concerned, in particular in order to allow the norms to adequately fit into the distinct corporate governance frameworks.”<sup>22</sup>

Indeed, it has to be borne in mind that shareholding structures across EU Member States inevitably play a very important role in shaping corporate culture as well as cooperating with institutional investor groups.<sup>23</sup> Companies with dispersed shareholding tend to be more focused on short-term goals in order to respond effectively to pressure from institutional investors. The same argument cannot be used in family-owned companies, where the management board may surely continue to focus on longer-term goals in order to ensure the continuity and sustainable prosperity of the corporation. If this factor is taken into consideration, then the monitoring of these companies by institutional investors as well as their engagement strategies must vary to adapt themselves to national characteristics and to be able to operate according to the respective corporate landscape.

It is therefore legitimate to argue that the presence of institutional investors in various EU Member States will potentially become a driver for change of corporate governance cultures via increasingly dispersed shareholding structures and the need for more “shareholder friendly” governance strategies. Nevertheless, not having reached a completely harmonised framework on shareholding structures across EU listed companies, we must admit that, at least in the current phase, institutional investors cannot be expected to exercise their

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- (b) a director of the institutional investor or the asset manager is also a director of the investee company;
  - (c) an asset manager managing the assets of an institution for occupational retirement provision invests in a company that contributes to that institution;
  - (d) the institutional investor or asset manager is affiliated with a company for whose shares a takeover bid has been launched.” Ibid. Article 3f § 2, 20.

<sup>21</sup> Ibid. Article 3f § 3, 20.

<sup>22</sup> Ibid. 7.

<sup>23</sup> More generally on this topic, see Cheffins (2008).



activities in the same way at the EU level since they interact with companies operating in markets with various socio-economic and cultural idiosyncrasies.

Therefore, the European Commission does not currently view the development of an EU Stewardship Code as a suitable or even realistic convergence model. The proposal for a Directive sets the minimum standards expected by institutional shareholders and asset managers to be ultimately formulated at the national level, as seen above. It remains to be seen whether this approach is preferred. Regardless of the potential efficiency of a future directive, the adoption of an EU Stewardship Code should not be completely disregarded. Such a code could broadly include the UK Stewardship Code's provisions. Most importantly, it is certain that, once again, the "comply or explain" principle would be called upon for the task of boosting the visibility of the diversified business practices amongst institutional investors<sup>24</sup> and corporate boards<sup>25</sup> in various EU Member States, which will most probably continue to vary, functioning as a reflection of the respective corporate governance cultures with which they interact.

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**24** In this regard, it should be noted that shareholding structures in the main EU capital markets, affecting national corporate governance cultures and models indirectly, have changed dramatically in the past decades. It is noteworthy that in Germany (a historically "concentrated ownership model" country) in 2012, 62% of the shares listed on the DAX index were held by institutional investors and 54% by foreign shareholders: Hopt (2013, p. 208). See also Roth (2013). Having been historically associated with concentrated shareholding structures, German listed companies are beginning to face the challenges for change in corporate culture to meet the expectations of predominantly foreign institutional shareholders. Similar observations can be made about the UK capital market where, according to the Office for National Statistics, foreign investors held in 2010 41.2% of the total value of the UK stock market, showing a constant rise from previous years: ONS (2012). Nevertheless, in other EU capital markets, for example France, where concentrated shareholding is the norm, institutional investors play, at least for the time being, a less significant role since the monitoring and engagement element is mainly exercised by a control shareholder or a group within the company communicating with the corporate board. Nevertheless, it should be borne in mind that although the concentration of capital still remains significant, there is a growing amount of participation by foreign investors (42.3% in 2009 of the total market value of CAC 40 companies), which may act as a driver for change in the future: Pietrancosta, Dubois, and Garçon (2013).

**25** When dealing with regulatory measures in the area of corporate governance, it should be borne in mind that different corporate governance models in Europe shape or inevitably influence regulatory agendas at the national level. For example, although in the UK the predominant feature of law has always been shareholder primacy, this view of the purpose of the corporation is not unanimously shared in continental Europe, where the corporation model is much more inclusive especially with regard to stakeholders. For example, the German model has traditionally been conceived as adopting a more holistic approach by allowing employees to actively participate in corporate governance systems. For an excellent analysis of various national corporate governance models at the EU level, see Dine and Koutsias (2013).



Regardless of the most suitable convergence regulatory tool in this area, it remains to be seen whether the future Directive will effectively promote this agenda and realistically strengthen the overall shareholder engagement trend.

## 2.3 Proxy advisor statements

The last area in which the “comply or explain” principle has been called into action more recently is related to the activities of proxy advisors. Proxy advisory firms are in charge of advising institutional investors and exercising the voting rights of the latter, who most often delegate these powers to such firms in an accelerating cost-saving framework.<sup>26</sup> The ever-growing influence of proxy advisors on institutional investors has triggered the need for the introduction of disclosure obligations in order to provide the necessary information to existing and potential clients on how they intend to exercise their activities and therefore allow them, as well as other market participants and regulators, to better understand their role and evaluate them in an adequate way.

In the Green Paper on corporate governance (Commission, 2011a, p. 14), the European Commission mentioned the possibility of regulatory intervention in this field, a statement that was recently followed by the proposal for a Directive aimed at encouraging long-term shareholder engagement, as will be analysed later in this paper (Commission, 2014). Feedback from stakeholders on the appropriateness of such an agenda was very positive, showing a clear preference for more transparency. The European Securities and Markets Authority (ESMA) subsequently began its own consultation period with various stakeholders, and in February 2013, published its Final Report (ESMA, 2013) on the results of the consultation and planning the introduction of an EU Code of Conduct, prepared by the Best Practice Principles Group (GBPP), an industry committee made up of proxy advisory firm representatives (GBPP, 2014). As we can observe, the regulatory choice for a Code of Conduct and the preparation of the Best Practice Principles for Shareholder Voting Research by an industry committee testify to the need for maximum flexibility as this is the first approach for the introduction of a disclosure framework at the EU level, with very few examples of similar attempts in EU Member States.

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<sup>26</sup> Taking into consideration investors' lack of expertise in deciphering complex corporate decisions and their lack of funds for thorough research of companies' profiles but, most importantly, the constant pressure on many asset managers and institutional shareholder groups to deliver short-term benefits to their clients, the need for proxy services has become indisputable in the modern investment era: Rose (2007, p. 897).

Before moving to the EU initiatives, it is necessary to draw some lessons from a comparative analysis between the UK and French frameworks. This will make the argument for more transparency at the EU level even more interesting since various national frameworks currently in place provide different disclosure spectrums and show the reason why the “comply or explain” principle needs to be maintained, at least for the time being, in the proxy advisory industry’s disclosure obligations. Therefore, by acknowledging and emphasising current divergent regulatory approaches in the UK and France, our analysis will present a more convincing argument for maintaining flexibility in this area. The argument for more flexibility focuses mainly on the fact that proxy advisory firms have not been previously subject to any disclosure obligations at the EU level, including some EU Member States, and it would be only utopic to assume that a uniform and widely applicable regulatory approach would bring substantial results in terms of transparency and comparability between different practices experienced at the EU level. It is therefore crucial for this initial period to contain a certain degree of flexibility, exemplified by the “comply or explain” concept, so that we can then see how the overall disclosure framework evolves in Europe before deciding to adopt more stringent measures. This argument becomes even timelier since the current EU regulatory policy adopts a rather different solution, as will be explained later in this paper.

Thus proceeding with the comparative analysis of the UK and French frameworks, it should be noted that the UK Stewardship Code, in its revised version and as analysed above, included the proxy advisory industry in a general way in its spectrum of application, thus expecting such firms to become voluntary signatories and to abide by its principles (UK Stewardship Code, 2012a). Conversely, the French competent authority (*Autorité des Marchés Financiers*, hereinafter AMF) adopted in 2011 a recommendation that, although it does not have binding force, takes a rather stricter approach than the UK one.

For example, acknowledging the risk of conflicts of interest when providing various services, the AMF recommendation asks proxy advisory firms to mention any possible ties to the company whose resolutions they are evaluating, to shareholders who have proposed resolutions at the general meeting for which the proxy advisors have provided a report for their clients, and lastly, to any persons who might control directly or indirectly the public company or majority shareholdings as mentioned above (*Autorité des Marchés Financiers (AMF) 2011*). On the contrary, the UK Stewardship Code contains a rather general obligation to publicly disclose the robust policy on managing conflict of interest that its signatories should develop.

Moreover, with regard to engagement with investee companies, the UK Stewardship Code leaves the signatory parties to determine the framework for this type of engagement, while providing some very general recommendations. Principle 6 of the Code states, for example, that “[i]nstitutional investors should

disclose the use made, if any, of proxy voting or other voting advisory services. They should describe the scope of such services, identify the providers and disclose the extent to which they follow, rely upon or use recommendations made by such services” (UK Stewardship Code, 2012a, p. 9). Nevertheless, the AMF recommends that “the proxy advisor submit its draft report to the relevant company for review, failing which the proxy advisor shall clearly state in its analysis report that the draft was not submitted for review and explain the reasons why” (AMF, 2011, p. 3). Moreover, under the condition that the company has informed the proxy advisory firm of its resolutions, the board’s reports and any other documents, at least 35 days before the general meeting, it has at least 24 hours to communicate any eventual remarks or comments. The firm has to include in its analysis report, upon the company’s request, its comments on its voting recommendations, under the condition that those comments are precise, enlighten the shareholders on the draft resolutions and do not discuss the general voting policy. If applicable, the firm corrects any material mistakes detected in its analysis report and previously noted by the company concerned and ensures disclosure to the investors as quickly as possible (AMF, 2011, p. 3).

The comparative analysis aimed to show the different mentalities around the level and quality of interventionism in the proxy advisory industry. The UK Stewardship Code, following a much more flexible approach with very general guidelines applicable to a broad series of market participants, creates a rather acceptable framework for proxy advisory firms, leaving them the freedom to operate in the market and disclose their practices accordingly. On the other hand, the French recommendation – albeit not binding – aims to shape a much more stringent framework which has not been unanimously accepted, taking into consideration the criticism from some respondents to the ESMA report that this recommendation has already created an unfavourable environment for some proxy advisory firms in comparison with other legal advisors or non-European firms (ESMA, 2013, p. 18). This probably shows that the industry is not yet ready, in its entirety, to accept a stringent framework and instead prizes maximum operational flexibility and the subsequent laxity of applicable rules. Different regulatory approaches to shaping and suggesting a possible engagement with issuers make it even more arduous to achieve a European consensus on this matter.

Therefore, going back to the EU dimension of the regulatory approach in this area, it comes as no surprise that proxy advisory firms are not required to follow the Best Practice Principles for Shareholder Voting Research but are merely encouraged to become signatories, and under that assumption, are expected to disclose compliance with (or deviation from) the Principles. Even though this soft law tool might not currently be the ideal regulatory approach

due to its extreme flexibility,<sup>27</sup> ESMA has also mentioned that if this process does not lead to satisfactory results or if market conditions create a need for more regulatory intervention, it will proceed to adopt more formal measures.

Regardless of the prospective regulatory framework applicable to proxy advisory firms, it is blatant that the “comply or explain” principle was the most obvious choice to start encouraging firms to disclose information about their practices while allowing them the maximum flexibility to deviate from the Principles recommended by GBPP without facing public criticism about the lack of engagement or willingness to participate in a soft law transparency framework. GBPP has therefore issued three main Principles, accompanied by guidance notes recommending how the Principles should be applied. The three Principles refer to the service quality (provision of services delivered in accordance with agreed client specifications and disclosure of research methodologies and, if applicable, “house” voting policies), the management of conflicts of interest (disclosure of a related policy that details the procedures for addressing potential or actual conflict of interest that may arise with regard to the provision of proxy services) and, lastly, the communications policy (disclosure of the policy for communication with issuers, shareholder proponents, other stakeholders, media and the public).

In their statements of compliance, proxy advisory firms should describe in a meaningful way how they apply the Principles and related guidance, disclose any specific information set out in the guidance, and where they do not comply with either the Principles or the relevant information, they should provide a reasoned explanation for their “non-compliance”.<sup>28</sup>

The most noteworthy issue, as far as the focus of this paper is concerned, is that the “comply or explain” framework has been unanimously accepted by the market participants in charge of this rulemaking initiative, due to its very flexible nature and the legitimacy it gives “non-compliance” since the latter forms part of the principle. It is therefore believed that, as we will show in the next part of this paper, the principle is perfectly adaptable to any kind of regulatory framework (binding Corporate Governance Codes for companies, non-binding Stewardship Codes, non-binding Codes of Conduct for proxy advisors) precisely because it legitimises both ideological stances, namely those of “compliance” and “non-

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<sup>27</sup> A slightly more stringent approach could indeed have been adopted to bring about much more concrete disclosure results: Sergakis (2014).

<sup>28</sup> Without going into further detail, we will nonetheless emphasise the very flexible nature and vague wording of some crucial provisions of this Code of Conduct which, coupled with the flexibility of the “comply or explain” principle, give substantial leeway to proxy advisory firms to continue to determine the way in which they conduct their business without necessarily avoiding some delicate issues for which they have been already criticised, the management of conflicts of interest being the most notable. On this last issue, see Klöhn and Schwarz (2013).

compliance” with a certain set of principles. Nevertheless, this ideological openness with regard to the flexibility of the party responsible for disclosing its practices also gives an equal degree of flexibility to treat the principle superficially, knowing in advance that all possible positions will be legitimised by the “comply or explain” concept.

On the other hand, as recently emphasised by the EC, “[t]he Commission will consider an initiative in 2013, possibly in the context of the revision of the Shareholders’ Rights Directive, with a view to improving the transparency and conflict-of-interest frameworks applicable to proxy advisors’ (Commission, 2012, p. 11). Indeed, with the proposal for a Directive aimed at encouraging long-term shareholder engagement and certain elements of the corporate governance statement (Commission, 2014), the European Commission moved in a rather surprising direction when it chose to require Member States to ensure that proxy advisory firms publicly disclose a series of information on an annual basis with regard to the preparation of their voting recommendations without any recourse to the “comply or explain” principle.

More specifically, proxy advisors will have to disclose the main components of the methodologies and models applied, the main information sources used, the eventual consideration and its content of national market, legal and regulatory conditions, the eventual dialogue developed with companies, the total number of staff involved in the preparation of their voting recommendations, as well as the total number of these recommendations provided in the year covered by the annual disclosure.<sup>29</sup> The proposal also provides that they should identify and disclose to their clients and the company concerned by their recommendations any actual or potential conflicts of interest that may exert an influence on their services, as well as the actions that they have taken to eliminate or mitigate this type of conflict.<sup>30</sup>

The first impression from the proposal for a Directive is that it creates a rather inconsistent framework with the EU Code of Conduct as previously analysed. This is due to the fact that, while very flexible, the Code of Conduct covers a considerable range of issues that, if combined with the related guidance, gives the market the chance to receive a considerable amount of information on proxy advisory firms. On the contrary, the European Commission seems to have opted for a much narrower focus of attention but without the flexibility of the “comply or explain” principle. This can possibly be explained by the need to convey the message that an absolute minimum “informational safety net” is guaranteed without recourse to a flexible disclosure framework but with more binding disclosure requirements. In this respect, the proposal mentions that “proxy advisors will only be subject to

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<sup>29</sup> Ibid. Article 3i § 2, 22.

<sup>30</sup> Ibid. Article 3i § 3, 22.

some basic principles to ensure accuracy and reliability of their recommendations.”<sup>31</sup> It therefore seems that the preference was clearly for a minimum of issues to be disclosed in a binding framework and thus without the risk of associating them with perfunctory explanations in case of deviation.

At the further level of analysis, it is rather unfortunate that the proposal chooses a rather different direction from that of the EU Code of Conduct at almost the same period. Would it not have been preferable to coordinate private and public efforts to shape an initial regulatory framework for proxy advisory firms in order to avoid further confusion and inconsistencies between different sources of rulemaking both at the national and at the EU levels? The main concern about the current proposal is that, by leaving it to Member States to require proxy advisors to disclose information on a specific series of issues, national frameworks will inevitably move towards this informational minimum without necessarily making the effort to trigger further reforms and create a more sophisticated and elaborate informational spectrum for the benefit of the rest of the market. At the same time, the Best Practice Principles for Shareholder Voting Research issued by GBPP will continue to exist at the EU level as a private-sector initiative and as a non-binding document that invites proxy advisory firms to become signatories and follow its more detailed principles while benefiting from the “comply or explain” framework.

The rather unfortunate result will therefore be that proxy advisory firms will be required to follow a minimum of binding disclosure requirements at the national level, while maintaining the discretion to adhere to (and probably not sufficiently engage with) a broader non-binding set of principles at the EU level. The main concern about this inconsistency is that it will become rather burdensome for the rest of the market to understand the information disclosed according to the prospective regulatory framework at both the national and EU levels. Moreover, it is rather unfortunate that the proposal for a Directive does not require proxy advisors to publicly disclose actual or potential conflicts of interest, but only to disclose them to their clients and the company concerned by their recommendations, whereas the EU Code of Conduct clearly favours public disclosure in this area. Although it is rather premature to predict the outcomes of these different regulatory initiatives, the EU agenda needs to take into serious consideration potential sources of informational inconsistency and confusion that will make the overall disclosure exercise somewhat burdensome and of little use to market participants.<sup>32</sup>

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<sup>31</sup> Ibid. 7.

<sup>32</sup> See also the arguments advanced by the European Commission with regard to the option of binding transparency requirements in combination with the EU Code of Conduct and in comparison with the other three possible options (no policy change/recommendation on disclosure requirements/detailed regulatory framework): Commission (2014, pp. 62–64).

## 2.4 “One concept fits all”?

Having analysed the “comply or explain” principle across different areas of activity, namely the ones of listed companies, institutional investors in proxy advisors, aiming to show the growing trend in the use of the principle, one question inevitably arises: can we realistically expect the same informational outcome and rate of compliance or deviation from all the above-mentioned regulatees? The principle itself emerged as an alternative to the rigidity of the “one-size-fits-all” concept that seems unpractical in corporate governance and, although still being used across these sectors, it becomes crucial to distinguish between the various activities of regulatees and to show whether “one concept fits all”.

Listed companies rely, amongst other things, on a continuous flow of investment. Their shareholders are a decisive factor for their future, providing the capital for company operations and expansion opportunities. Also bearing in mind that shareholders are at risk of losing only their investment, with no other implications for their personal assets, the relationship that they build with an investee company is based exclusively on a common profit-making goal without any element of a “client – service provider” relationship. This observation leads us undoubtedly to the conclusion that companies should feel relatively free to use both parts of the “comply or explain” principle fully, because although there is an expectation from the investor community for their portfolio to generate profits, the means used to ensure their strategies’ success cannot be clearly identified and confined into a strictly contractual obligation to provide services in a predetermined way, as institutional investors or proxy advisors would do with their clients.

Turning our attention to institutional investors or proxy advisors, the situation might be interpreted slightly differently since they provide management services to their clients, and these services are specified contractually. Therefore, it could be argued that the expectations of the recipients of information disclosed could be slightly greater with regard to the use of the “comply or explain” principle in both instances, namely they could expect either a higher rate of compliance or much more detailed explanations in the case of deviation. Moreover, it could be also argued that due to the presence of a “client – service provider” relationship, institutional investors and proxy advisors should feel less free to deviate from best practices not just because this would trigger further complaints from their existing clients but also because this could severely affect their reputation and attractiveness in the eyes of future clients.

On the other hand, the same situation could be interpreted inversely, namely that service providers, as long as they meet their contractual engagements to clients, should feel freer not to follow best practices if the current methods and operating strategies applied meet their clients’ expectations, even



though they consist of alternative ways of doing business that do not coincide with the best practices included in a soft law code. Nevertheless, this latter opinion should be validated with reservation, since compliance with a set of best practices is not intended for existing clients alone but should, in the eyes of the regulator and the investor community, take into consideration wider implications and needs of future clients and stakeholders. This means that service providers should go beyond their contractual arrangements with their existing clients and strive to increase their reputation via the disclosure of useful information while containing commonly acceptable standards or, at least, providing a truly meaningful explanation when they choose not to do so.

The exact repercussions of deviation for all the aforementioned regulatees cannot be predicted with certainty because they interact with various parties and in different situations. As we will show later in the paper, the recipients of the information disclosed tend to prefer a “box ticking” approach to formal compliance instead of an in-depth analysis of a meaningful explanation provided in the case of deviation. Regulatees are therefore constantly under pressure to comply with the principles and to avoid the “non-compliance” scenario, and this inevitably prevents the “comply or explain” principle from fully exploiting its different forms and fields of communication with other parties. These should nevertheless not mean that “one concept fits all” since, as was shown, expectations and pragmatic considerations may differ according to the relationship between providers and recipients of the information disclosed. Hence both parts of the principle should be equally acceptable by its users, irrespective of the nature and source of the information. For such an objective to be met, further analysis is needed on how all parties use the principle and perceive the content of disclosure. After having analysed the three main regulatory fields in which the principle has been put into practice, we will thus need to “deconstruct” this ideological concept and show the veritable merits but, most importantly, the dangers arising from its superficial conception and use by market participants which will inevitably weaken it in the future unless a consensus can be reached on its role and usefulness.

### **3 The deconstruction of the “comply or explain” principle**

#### **3.1 Flexibility of the “comply or explain” principle**

As previously mentioned, the “comply or explain” principle offers maximum flexibility to extremely diverse fields of activity, incentives and strategies.



Various market actors’ unique idiosyncrasies cannot be channelled to a specific pattern and cannot be predictable in capital markets, where moral hazard, market manipulation and limited knowledge (along with ignorance) reach their apogee.<sup>33</sup> Therefore, the principle acknowledges the inherent deficiencies of every regulatory approach that would opt for a unanimously applicable framework without any possible derogation or flexibility. Our examination of the principle’s application to the areas of listed companies, institutional shareholders and proxy advisors, as developed in Part 1, shows that the common denominator is the extreme diversity of different market participants within a single sector, their difference in size or experience, or, taking the debate to the national, EU or international levels, their culture about how their activities should be thought of and carried out. It is exactly this difficulty in producing rules and expecting an extremely diverse business community to apply them in the same way that initially made the “comply or explain” concept so suitable to acknowledge, accept and legitimise the preservation of individual characteristics, under the condition that the party that does not comply, fully or partially, with a set of rules must explain the reasons for this choice.

Moreover, acknowledging this diversity, it has always been in the regulators’ best interests to develop a framework that encourages transparency without imposing stringent obligations. The prevalence of “principles-based” standards and soft law measures has fitted elegantly with the need to ensure this kind of regulatory flexibility and has undoubtedly been appreciated by the business community. In fact, the idea that the initial recourse to soft law measures was somewhat “biased”, aiming to preserve and accommodate business needs instead of encouraging companies to come forward in a more efficient way, cannot be entirely excluded from our debate. Therefore, quite legitimately so, the defenders of “hard law” measures continue to consider corporate governance in particular to be a legitimate area for much more intrusive regulation of companies’ lives.<sup>34</sup> The criticism of the laxity of soft law measures and parties’ considerable leeway to avoid greater transparency vis-à-vis the recipients of the information disclosed can be especially formulated with regard to the stewardship movement and the best principles for proxy advisors. Nevertheless, stewardship trends have only recently emerged and therefore there could still be an optimistic perspective that soft law will be sufficiently convincing in allowing parties to increase

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<sup>33</sup> See for example Biondi (2011).

<sup>34</sup> For a discussion on the debate “soft law v. hard law” as far as companies are concerned, see Aguilera, Goyer, and Kabbach-Castro (2013, pp. 22–28). See also the very interesting study of MacNeil and Li (2006).

transparency on their activities and engage in a more fruitful way with other market actors. As the FRC wisely stated, “[t]he Stewardship Code, unlike the UK Corporate Governance Code, is still in its infancy and behavioural change will take time” (FRC, 2013, p. 4).

More generally, the criticism levelled against soft law measures, especially the “comply or explain” principle, is that the parties use it fairly superficially, and therefore the chance for more transparency and better communication is severely compromised.

## 3.2 Users’ superficial conception of the principle

### 3.2.1 Information providers

Starting chronologically from 1992 when the “comply or explain” concept was formally introduced in the UK corporate governance landscape, it was hoped that companies would take full advantage of the principle, and information recipients would have the chance to gain a sufficient understanding of corporate strategies and build a more fruitful relationship with investee companies. Nevertheless, even in the UK framework where the principle has been present for more than 20 years, serious problems persist with regard to its conception, its use and its treatment by all concerned parties. Moreover, since the adoption of the principle at the EU level with Directive 2006/46/EC, it was expected that companies in other EU Member States would sooner or later adhere to this philosophy while maintaining their idiosyncrasies. The rather disappointing outcome observed arises from the fact that both aspects of the principle suffer from poor-quality engagement.

As far as the “comply” part of the principle is concerned, it is rather frustrating to see that the perception of the level of compliance<sup>35</sup> as well as the level of full compliance<sup>36</sup> varies significantly from one European country to the next. This observation does not necessarily mean that non-compliant regulatees reject the principle in general nor that the principle lacks an effective mechanism to orientate companies towards a certain ideological stance in

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<sup>35</sup> A distinction needs to be drawn between formal or mere compliance and real compliance. The former refers to a simple declaration that a company has complied with the provision that may not necessarily mean that a company has also satisfied the underlying reasoning of the provision itself but has just declared compliance to satisfy the market’s need for a good compliance rate. The latter denotes a genuine compliance attitude, not only with the provision itself but, most importantly, with its underlying justifications.

<sup>36</sup> Compliance with the full number of soft law provisions.

accordance with best practices. We must bear in mind that “non-compliance” is legitimised through the explanatory part of the principle and should be perfectly acceptable. Moreover, in theory, “non-compliance” makes the principle more useful for regulatory purposes since it conveys important messages for the adaptability of the applicable provisions and the needs of regulatees. Nevertheless, our main concern is that the variable rate of compliance is not accompanied with meaningful explanations and therefore the overall effectiveness of the “comply or explain” mechanism becomes problematic.

Starting with the “comply” part of the principle, in some countries, such as the UK, overall compliance is believed to be rather satisfactory and highly praised, serving (at least for the UK market) as a legitimate justification for continuing with soft law measures. According to the latest UK annual review (Thornton, 2013), 57% of companies reported full compliance with the Corporate Governance Code, and the remaining 43% (which declared non-compliance) had difficulty in complying with very few provisions of the Code. This of course does not necessarily mean that real compliance with soft law provisions is achieved since, as previously mentioned, companies may be just pushed to declare formal compliance without actually showing genuine engagement with the purpose of applicable provisions. Nevertheless, this kind of percentage gives the market the impression that the code is efficient since most of its provisions are respected by companies.

On the other hand, in continental Europe – where the “comply or explain” principle continues to be applied but in a rather less straightforward or ill-understood way<sup>37</sup> due to cultural differences and different corporate governance models – the compliance rate seems to convey rather mixed messages. For example, in Germany, the percentage of full compliance with all provisions of the code is not entirely satisfactory if we take into account that the compliance rate for the DAX 30 companies for most of the provisions is higher than 90% but not for all of them (Roth, 2013, p. 353). Moreover, smaller firms tend to show much lower compliance rates in general (Roth, 2013, p. 353). Therefore, even if the majority of the provisions continue to be followed by most DAX 30 companies, the level of full compliance with the whole array of provisions is not satisfactory and the same observation needs to be put forward with regard to smaller firms that struggle to

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**37** It should be borne in mind that the principle itself was designed initially for the UK market and the flexibility given to the providers of information was crucial to the viability and vibrant character of the City. Transposing the principle and its flexibility in continental Europe was therefore bound to face (and continue to fuel) certain cultural obstacles since CEOs from other countries still consider the principle to be a futile exercise and they are not entirely convinced of the merits that it brings into companies’ lives. See, for example, the very interesting empirical data, with regard to UK and German CEOs, gathered by Sanderson et al. (2013).

comply at a satisfactory percentage with soft law provisions. Therefore, the principle itself inevitably becomes partially unconvincing and receives a considerable amount of criticism.<sup>38</sup> For example, in a very interesting empirical comparative study of corporate governance statements in the UK and Germany, it is fairly obvious that German companies are still struggling with the “comply or explain” itself, since the number of deviations is much greater than in the UK and the explanations provided are not always satisfactory.<sup>39</sup>

As mentioned above, a high rate of deviation is not alarming *per se* since the principle encompasses and legitimises both ideological stances. Instead, it is a combination of a low compliance rate with poor quality of the explanations provided that makes the overall mechanism of the “comply or explain” principle problematic and triggers further considerations for possible reforms. As far as the “explain” part of the principle is concerned, if companies do not provide any or sufficient explanation with regard to their choices, recipients are unable to understand the underlying reasons why commonly acceptable rules are not followed. Perfunctory explanations create a further gap in communication amongst market disciplines as it clearly shows a lack of engagement and an unwillingness to become more transparent. In fact, the same report states that companies have, in their majority, ignored the FRC’s latest recommendations regarding the provision of meaningful explanation in case of “non-compliance” (FRC, 2012b).

Indeed, the FRC began in 2012 a consultation process in that respect, after having met with senior investors and companies in December 2011 to discuss the notion of “meaningful explanation”. The results of those meetings were

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**38** See, for example, the intense debate in Germany in 2010 around the efficiency of the principle itself, questioning soft law measures. The Report was drafted by a Government Commission on the German Corporate Governance Code: Bericht der Regierungskommission Deutscher Corporate Governance Kodex an die Bundesregierung (2010) <http://zip-online.de/volltext.html?id=2a38a4a9316c49e5a833517c45d31070> accessed 9 November 2014.

**39** Sanderson, Seidl, and Roberts (2012). Even if these data may imply that the most important issue is the lack of meaningful explanations and not the poor rate of compliance in itself, it seems rather complex to decipher the inner motivations of “non-compliance”. Could for example “non-compliance” be seen as the natural outcome of a different and perfectly legitimate company profile that justifies the rejection of a set of best practices? Or could it be interpreted as a general aversion to “mainstream” suggestions and the “comply or explain” principle in general? This observation is particularly relevant in countries where corporate culture is very different from the one present in the UK. Interviews conducted in the above-mentioned comparative study show that many German CEOs do not actually understand the principle and that they feel that they have to abide by a system that is not always meaningful. Hence, it would be plausible to assume that, unless new empirical evidence emerges in the future on the inherent motivations for “non-compliance”, there can be no certainty on the underlying justifications of this ideological stance adopted by the users of the principle.

published in February 2012 and the FRC issued three criteria that could be a model to inspire similar activities undertaken with the business sector under the purview of other national authorities: firstly, the explanation should provide the context and historical background; secondly, it should provide a convincing argument for the solution adopted by the company and further analyse any potential moderating actions that the company has taken to solve any eventual additional risks and to ensure a certain level of compliance with the code's provisions; thirdly, the company should explain whether the deviation was limited in time and when it intends to resume compliance with the code's provisions.

The overall impression is clearly that there is still a lot of room for improvement in disclosing meaningful explanations. In annual reviews of other EU Member States,<sup>40</sup> the results regarding meaningful explanations are much more disappointing, clearly showing a tendency not to engage in honest exposure when deviating from the Code.<sup>41</sup> More recently, the European Commission issued a Recommendation on this issue, predominantly applicable to listed companies following article 20 (1) of Directive 2013/34/EU,<sup>42</sup> by emphasising the need for high-quality reporting in the cases of both formal compliance and non-compliance, namely departure from the provisions of corporate governance codes.<sup>43</sup>

First of all, the Recommendation encourages listed companies to describe how they have applied the soft law provisions on the topics of major importance for shareholders, following the framework of article 20 (1). Companies need to satisfy the criteria of clarity, accuracy and comprehensibility while referring to their particular idiosyncrasies to enable shareholders, investors and stakeholders to gain sufficient understanding of their corporate governance system.<sup>44</sup>

Secondly, in cases of non-compliance,

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<sup>40</sup> For example, Belgium and Germany, only to name a few. For Germany, see the very interesting empirical data from Sanderson et al. (2012, pp. 1–36).

<sup>41</sup> For example, according to the latest French review of corporate governance statements, the AMF observed that 19 out of 25 companies that summarised deviations from the Afep–Medef Code in a single paragraph/table did not present an exhaustive table and omitted certain deviations from the Code, especially with regard to remuneration issues. Moreover, only six of these companies provided complete information on deviations with regard to remuneration issues: AMF (2013, pp. 76–77).

<sup>42</sup> Commission (2013) (n 10).

<sup>43</sup> Commission Recommendation of 9 April 2014 on the quality of corporate governance reporting (“comply or explain”) [2014] OJ L109/43.

<sup>44</sup> Ibid. Section II, 46.

companies should clearly state which specific recommendations they have departed from and, for each departure from an individual recommendation: (a) explain in what manner the company has departed from a recommendation; (b) describe the reasons for the departure; (c) describe how the decision to depart from the recommendation was taken within the company; (d) where the departure is limited in time, explain when the company envisages complying with a particular recommendation; (e) where applicable, describe the measure taken instead of compliance and explain how that measure achieves the underlying objective of the specific recommendation or of the code as a whole, or clarify how it contributes to good corporate governance of the company.<sup>45</sup>

It is hoped that this initiative will gradually contribute to the convergence of reporting practices across EU Member States, but it is doubtful that such a goal can be achieved via a simple recommendation. A much more convincing approach would have been to incorporate these provisions into the relevant Directives (mentioned above), to accelerate convergence in this area. Requiring companies via a Directive to clarify further their own idiosyncrasies to better inform the market of the underlying reasons for their compliance or departure from certain provisions, as well as to provide meaningful explanations when they do depart from a code, would have inevitably brought much more concrete results in the near future. Although the counterarguments for flexibility could be advanced in this scenario, we firmly believe that the “comply or explain” principle offers enough flexibility to companies when they do not follow certain provisions, and it would therefore have been a legitimate compromise to require them to provide meaningful explanations via a Directive.

The current Recommendation testifies to the increasing influence of companies on regulatory initiatives. The situation becomes even more preoccupying if we bear in mind that while it is clear, from a strictly legal point of view, that any violation of the “comply or explain” principle can trigger sanctions, companies continue to avoid fully respecting the framework and national authorities seem reluctant to impose sanctions. Indeed, it is rather difficult to impose sanctions, especially for non-respect of the explanatory part of the principle, since its subjective character – dependent on the individual circumstances of each company – can become a convincing defence argument in the face of alleged inconsistency or disclosure of inaccurate information, especially in the absence of proof. Moreover, a causal link between deficient quality of the explanatory part and a loss suffered as a result of this situation could be even more difficult to demonstrate.

Examining the respect of the principle under the “institutional shareholders” perspective and the disclosure of information with regard to the exercise of their

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<sup>45</sup> Ibid. Section III, 46.

activities under the UK Stewardship Code, the results seem equally frustrating. Indeed, according to the latest review conducted by the FRC (2013), half of the signatories have not even updated their compliance statements since the latest reform of the Code in 2012 that introduced more soft law principles. Therefore, even if they comply formally with the Code, this kind of compliance remains superficial due to its pure formality and its lack of substance since it only refers to and reflects the partial spectrum of the Code as contained in its initial 2010 version. Moreover, those that have updated their compliance statements provide poor-quality information, especially with regard to the management of conflicts of interest and the collective engagement issues prescribed in the Code. Although adherence to the Code is purely voluntary, the signatories do not sufficiently engage with the Code and the “comply or explain” principle itself. The same concerns could be shared with regard to the newly established framework for proxy advisors, as previously described, whose purely voluntary adoption might create deficiencies in the quality of engagement from proxy advisory firms and might risk severely weakening the importance of the “comply or explain” principle if its conception and use remains superficial. Therefore, more research will be needed in the near future after the first series of publication of proxy advisory compliance statements to these principles occurs.

As an initial general assessment of the quality of engagement by the information providers, it seems that they have conceived of soft law measures as an effective excuse for avoiding a genuinely transparent mentality on how they conduct their business and how they are willing to engage with other participants. Although this argument could be extended to claim that soft law measures have been initially conceived and applied to accommodate business needs and are therefore not essentially purported to serve as a convincing regulatory tool for the introduction of an informational transparent framework, we firmly believe that the essential problem lies with the use of soft law measures and not with their identity as such. Flexibility might have been one of the drivers for change and the adoption of soft law measures, but it can certainly not be transformed into an “illusion making” mechanism if the provider of the information is willing to engage effectively in this framework. It is therefore not the “softness” of the legal framework as such that is problematic, but the fact that market participants continue to rely upon flexibility to avoid better informing the rest of the market.

### 3.2.2 Information recipients

As far as investors are concerned, despite their interest in these statements, they seem not to fully appreciate the principle itself since they interpret both the compliance and explanatory parts of the principle rather mechanistically.

Investors do not always react predictably since they are much more concerned about the financial performance of a company rather than compliance or explanatory issues regarding a specific set of rules Arcot, Bruno, Faure Grimaud (2010). The corporate short-termism and lack of “genuine” engagement with boards<sup>46</sup> has led shareholders to be much more concerned about profits and the management of their portfolios by financial intermediaries than whether the company has made a real effort either to comply with the recommendations of a corporate governance code or to explain in a detailed and substantial way its distinctive features that justify deviation from the code.<sup>47</sup> This conception of the usefulness of corporate governance statements inevitably creates an almost automatic preference for “mere compliance” statements in order to ensure that the investee company follows a certain set of recommendations and broadly acceptable principles, without therefore concentrating on the actual compliance and the subsequent adoption of corporate governance practices that show that they are adopted to serve the underlying purpose.

What is even more alarming is that investors tend to start paying attention to compliance or non-compliance issues only when corporate decisions create losses. In other words, as long as the corporate culture adopted proves to be profitable for their investment, they tend to be indifferent even in cases where a non-compliant company does not provide sufficient explanation for its deviation from a code.<sup>48</sup> The same concern could be expressed with regard to the disclosure of information relevant to the exercise of stewardship responsibilities by institutional investors since their clients will most likely be indifferent to a “non-compliance” statement if their portfolio remains profitable. Nevertheless, it has to be borne in mind that empirical studies with regard to the perception of stewardship statements by investors have not yet been published due to the very recent introduction of the UK Stewardship

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**46** Namely an engagement that perceives the company as a vehicle for long-term investment and performance and not as a short-term profit mechanism as it has been seen in the recent financial crisis where institutional shareholders and corporate boards were perfectly aligned in that respect. It should also be borne in mind that our study is not focused on the relationship between short-termism and liquidity-provision driven strategies. Indeed, the latter may have a legitimate justification, namely in the case of capital raising needs. Moreover, it should be acknowledged that when liquidity is provided for speculative reasons, these strategies may reinforce pro-cyclical waves that will inevitably hamper the stability of financial markets.

**47** This is inevitably due, amongst other factors, to the gradual dissociation of shareholders from the management of corporate affairs. On the general issue of the separation of shareholding from control, see the seminar work of Berle and Means (1932).

**48** Ibid.



Code. It will therefore be a very interesting field of research to observe a possibly similar approach from individual investors towards statements arising from institutional shareholders or proxy advisors, as they have been previously analysed.

Having “deconstructed” the “comply or explain” principle by showing its merits and shortfalls, this paper aims now to “reconstruct” the principle and provide for pragmatic solutions to restore its convincing force and efficiency for its users.

## 4 The reconstruction of the “comply or explain” principle

### 4.1 The reinforcement of an engaged interaction between different market actors

Having emphasised the superficial conception and use of the “comply or explain” framework of both information providers and recipients, it is vital to begin any proposal by reconsidering the quality of engagement in the relationships built between market participants. Proven to be a very flexible disclosure tool for corporate governance statements, stewardship statements and proxy advisory statements, the “comply or explain” framework is ideally positioned to coordinate a *nexus* of potentially fruitful and interactive relationships with one common denominator: all parties that follow the principle, participate in the investment chain and should all be interested in evaluating and being evaluated by other market participants while respecting with the same rigour, flexibility and openness offered by this principle.

If companies, institutional investors and proxy advisors follow the principle with the same mindset, the engagement conundrum might be more realistically resolved since all parties involved in the investment chain will accept *a priori* that they have an equal chance to declare compliance with a set of rules or non-compliance associated with meaningful explanations. Under this assumption, all parties should equally value both ideological stances and the chances of rejecting a “non-compliance” statement will lessen.

As an overall impression, although the adoption of the “comply or explain” principle at the EU level has clear potential to better connect corporate boards with shareholders and stakeholders who may be affected by companies’ activities, via the provision of a series of information that can

give rise to fruitful discussions and mutual understanding of business priorities, it has not yet been perceived as a realistic path of exposure and communication by both companies and investors. A consistent deficiency in the quality of the explanations provided, in a non-compliance scenario, will not only jeopardise the information provided to investors but, most importantly, will damage the principle itself and weaken its foundations. As has been wisely stated, “failure to provide an adequate explanation increases the risk not only of the company being perceived as acting illegitimately but also of the code being seen as lacking legitimacy” (Sanderson, Seidl, & Roberts, 2013, p. 6).

In order to overcome superficial and merely technical behaviour around the use of corporate governance statements, both companies and investors should start disconnecting their decision-making processes from short-term benefits that seem to be the source of this problematic situation. It would be useful to remember that corporate boards are under constant pressure to deliver results not just according to their own possible short-term targets but, most importantly, the targets fixed by their shareholders, which may demand an even more aggressive decision-making strategy. The preference for an aggressive strategy, which might well go against the company’s long-term performance, is justified in theory by the pressing need of corporate boards to satisfy the “dependence of markets on constant company-relevant data streams as a basis for stock allocation decisions and associated professional communications. This in turn creates a compelling pressure on corporate managers to generate fresh ‘news’ indicative of perceived business ‘progress’, in an effort to influence future share price movements.”<sup>49</sup> This general trend towards a short-term informational and operational focus, accentuated with a burdensome and ever-growing corporate reporting framework, does not allow much space for optimism with regard to the change of corporate culture and the reorientation of targets towards long-term objectives. Markets need constant confirmation of an optimistic corporate scenario in order to justify their investment decisions and reassure investors of the “rationality” of their short-term objectives. This cultural phenomenon is obviously unsustainable, for both companies and investors, since it draws the attention of market participants away from the need for business innovation and growth, and focuses predominantly on the illusionary shaping of optimistic news that is reflected in share price movements.

Corporate greed has of course been observed and severely criticised in the wake of various corporate and financial scandals, and it is very difficult to

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<sup>49</sup> Moore and Walker-Arnott (2014). The authors call this phenomenon “informational centrality”.

predict with certainty whether directors would reorient their strategies as soon as investor pressure for short-term returns would disappear (Weinstein, 2013, p. 54). But it would be at best illusory to isolate management short-termism from the identical trend arising from the “bottom”, namely the investor community, for the reasons explained above. Moreover, financial intermediaries have long reproduced and enhanced the short-term investment trend due to the fact that their evaluation is based on short-term performance and the additional development of good stewardship activities on behalf of their clients is mostly irrelevant, hence the lack of incentive for engagement with companies (Wong, 2010, p. 409). Their evaluation is correlated with a market-based notion of performance, mainly driven by capital market gains and speculative trading, and is therefore detached from a stewardship culture. The recent proposal for a Directive aimed at encouraging long-term shareholder engagement, as previously analysed, contains further provisions that aim to increase the transparency of the investment strategy followed by institutional investors, as well as their arrangements with asset managers.<sup>50</sup> The provisions are surprisingly

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**50** Article 3g of the proposal requires Member States to ensure that institutional investors publicly disclose how their investment strategy is aligned with the profile and duration of their liabilities, as well as how it contributes to the performance of their assets on a medium to long-term basis. Institutional investors are also required to publicly disclose any arrangements that they may have with asset managers with regard to:

- (a) whether and to what extent it incentivises the asset manager to align its investment strategy and decisions with the profile and duration of its liabilities; (b) whether and to what extent it incentivises the asset manager to make investment decisions based on medium to long-term company performance, including non-financial performance, and to engage with companies as a means of improving company performance to deliver investment returns; (c) the method and time horizon of the evaluation of the asset manager's performance, and in particular whether, and how this evaluation takes long-term absolute performance into account as opposed to performance relative to a benchmark index or other asset managers pursuing similar investment strategies; (d) how the structure of the consideration for the asset management services contributes to the alignment of the investment decisions of the asset manager with the profile and duration of the liabilities of the institutional investor; (e) the targeted portfolio turnover or turnover range, the method used for the turnover calculation, and whether any procedure is established when this is exceeded by the asset manager; (f) the duration of the arrangement with the asset manager. (Commission, 2014, pp. 20–21)

Article 3h also includes provisions applicable to asset managers who are required to disclose on a half-yearly basis to the institutional investor with which they may have an arrangement, as analysed above, how their own investment strategy complies with that arrangement and how it contributes to the medium to long-term performance of the institutional investor's assets: Commission (2014, p. 21).

detailed for such an issue, which has for a very long time remained mostly a private matter between various financial intermediaries, and they are purported to engage institutional investors and asset managers in a disclosure exercise to the rest of the market to explain *inter alia* how their actions contribute to the medium to long-term performance of the assets invested.

It is therefore hoped that, if followed as expected, this type of disclosure will help both intermediaries and the rest of the market to obtain a common understanding of their respective activities and the contribution of the latter towards a different, namely more sustainable, investment mentality.<sup>51</sup> As previously mentioned, the merits and shortfalls of disclosure are inevitably unpredictable as the information provided can be used as a beneficial means of communication and interaction or as a profitable tool for speculative purposes. Encouraging market participants to expose their strategies and operating methods will inevitably be a very difficult and delicate task that may need much time before becoming a convincing argument and being seen as the only viable solution for a better investment environment. Moreover, the interaction between different parties cannot be guaranteed merely by the growing disclosure trends, as shown in this paper, since there is no proof – for the time being – that these parties would be willing to benefit from each other's information and participate in a constructive dialogue. Therefore, under a more realistic scenario, this interaction could only occur between parties that have already engaged in long-term strategies and are in a position to link up with other parties following the same investment pattern.

Nevertheless, as was previously explained, it would be very risky to rely exclusively upon those parties that have already acquired sophistication and solid strategies for long-term investment for such a dialogue to occur. The reason for this scepticism is that the dialogue would only occur between these sophisticated parties and not regularly but when they would decide to develop an ad hoc dialogue with another contractually related party in order to ensure that their mutual objectives are met in a specific deal.

Therefore, acknowledging the perfectible character of disclosure trends as well as the risk of instrumentalisation by the users of information, it seems more plausible to invest in this regulatory path, whereby market participants are constantly encouraged to disclose information about their strategies and to make opportunities for dialogue with other participants more feasible. The availability of information

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<sup>51</sup> For a much more critical approach on this point, asserting that the “mandatory disclosure requirement cannot be expected to increase the low levels of engagement because it neither creates financial incentives nor lowers the cost of engagement. On the contrary, it may increase costs if institutional investors feel pressured by their beneficiaries or others to increase their engagement”, see Birkmose (2014, p. 236).

will inevitably give rise to some speculative trends, but this would be offset by increasing awareness amongst parties and allowing them – for the first time – to be in a position to participate in a wider debate about balanced corporate governance and long-term goals. It is the educational element of disclosure that needs to be preserved even if some of its components will be sacrificed for short-term purposes.

Of course, such disclosure trends will function under the “comply or explain” principle and therefore the “safety net” of this educational effort will need to be strengthened with further efforts to convince parties that “compliance” and “non-compliance” related information are both useful for awareness and dialogue purposes.

The need to reconstruct the principle itself based on this new assumption is made even more vital due to empirical studies, mentioned below, showing that the main attitude of all involved parties is a mere “box ticking” approach and there is no need for better understanding of the individual circumstances that have driven a party to deviate from a set of rules.

## 4.2 The acceptability of the principle in both “compliance” and “non-compliance” scenarios

According to data gathered from interviews conducted with CEOs from amongst the 130 largest listed firms in the UK and Germany, companies in both countries feel under constant and increasing pressure to fully conform with all the principles of their national corporate governance code even though the “comply or explain” principle clearly allows them to deviate and provide a meaningful explanation for such a choice. Therefore, even if deviation is essentially perfectly compatible with the principle, in practice this opportunity is severely compromised since the conception of compliance remains attached just to the “comply” part of the principle for both companies and investors (Sanderson et al., 2013, p. 19). The constant pressure to conform fully to a set of best practices attests to another fundamental issue which refers to the inherent rigidity of the “comply or explain” principle up to a point where the latter begins worryingly to resemble the “one-size-fits-all” approach of hard law from which it was, purportedly, designed to escape. Indeed, although initially designed with the aim to offer flexibility and “breathing space” to companies that, for a certain period of time, may have found it more useful for their purposes not to comply, the principle itself, as it is currently interpreted and used by the market, has become so rigid that it seems practically impossible for a company to feel free not to comply for fear of facing dissatisfaction from the investor community.

Bearing this element in mind, it would of course be utopic to neglect that the twofold nature of the principle aims in essence to guide the regulatee towards

formal compliance in the long term since the framework wherein it functions consists of best practices and not ordinary practices that may include any kind of practices, including alternatives to the best ones. In other words, the encouragement and invitation to comply with a set of best practices may imply that the latter are considered the preferred ones and that possible deviation is not always the preferred outcome. This underlying rigidity of the principle, whereby all regulatees are expected in essence to comply formally in the long run and not to deviate, should be seriously challenged as, if it persists in the common perception of the investor community, might have even worse repercussions on regulatees than the current ones.

Does this mean that the original design of the “comply or explain” principle considered that deviation should not necessarily have the same value and therefore same amount of appreciation by the market when it is disclosed as the regulatee’s position? It is our belief that the mechanistic perception of compliance as well as superficial rejection of deviation does not have its origins in the principle’s infancy but is mostly due to a distorted taste for “box ticking” and automated use of services that favour form (simple declaration of compliance) over substance (declaration of non-compliance along with explanations).

Of course, the superficial use of the principle and the automatic rejection of deviations need also to be interpreted as a sign of mistrust in the market and underlying belief that explanations will rarely inform the recipients of the information disclosed in a realistic way. This has partially originated in the continuous provision of perfunctory explanations by companies and risks expanding as a trend if the regulatory framework does not intervene for the improvement of the content of information in this area as well as the dialogue between market participants.

This ongoing situation should alarm all involved parties for the future of the principle since it should be borne in mind that attachment to just one part of the principle will make the whole disclosure process less convincing for future regulatory measures in the capital markets sector. As has been wisely observed, the “comply or explain” principle is essentially a

meta-legitimation mechanism in that it invites monitors to make judgments, not only on the legitimacy of regulatee action but also on the overall legitimacy of the underlying code and its provisions. They do this either in simplistically (and inappropriately) by counting deviations or in a more nuanced way by examining the quality of explanations given for deviating. (Sanderson et al., 2013, p. 4)

But adding to previous worrying signals, the natural and mechanistic preference for “mere compliance” statements makes non-compliance statements even less attractive, and therefore ultimately useless for informational purposes. Such non-compliance statements tend to be perceived as a typical declaration about

the impossibility of complying with the code, instead of triggering a further need to understand the overall philosophy of the corporate strategy described in such a statement. This situation can only reinforce the mechanistic use of the principle and weaken the need for more useful information since users would remain focused on “formal compliance” and ignore the information accompanying “non-compliance”. Market actors therefore run the risk of being increasingly less interested in understanding the true reasons behind “non-compliance” and favouring, almost automatically, mere compliance declarations without actually really understanding the superficial information received.

In other words, if the future regulatory target is to change this dynamic, a non-compliance statement, assuming it is well justified and gives useful insight into the company’s philosophy and reasons for deviation, should not be considered a failure in the company’s regulatory approach or compliance (Seidl, Sanderson, & Roberts, 2009). Companies’ most important task would therefore be the coherent disclosure of their philosophy which, though possibly not sufficient at all costs, provides useful data to investors and allows them to benefit much more from an enriching and understandable statement that targets and analyses deviation from a set of rules. This approach is strongly backed by the Financial Reporting Council (FRC), which has already clarified in the most obvious way that “[w]hilst shareholders have every right to challenge companies’ explanations if they are unconvincing, they should not be evaluated in a mechanistic way, and departures from the Code should not be automatically treated as breaches” (FRC, 2012c). The same emphasis is given in the UK Stewardship Code (2012a, p. 4) but, quite surprisingly, is absent from the Best Practice Principles for Shareholder Voting Research, prepared by the Best Practice Principles Group (GBPP) (2014).

It is therefore essential to strengthen this “open culture” for explanations of deviation from rules so that all parties can feel equally free to declare a deviation without the fear of being automatically criticised, or even isolated, from the rest of the market.<sup>52</sup> To enshrine such a culture in market actors’ consciousness, soft monitoring powers of the principle itself could be developed in order for monitoring bodies to provide an official dialogue framework between all involved parties in the investment chain and therefore give the “comply or explain” principle its full potential. Indeed, our proposals in the third and final part of this paper aim to show that since market participants have not been in a position or have avoided making full use of both parts of the principle, a reorganisation of the framework surrounding the principle should be put in place. This reorganisation needs to consist of soft monitoring exercised by a Panel belonging to the national competent

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<sup>52</sup> Or “culture of departure from code recommendations” as it has been named by the European Company Law Experts (2013, p. 6).

authority and to which the paper will now turn. The main role of the Panel would thus be to change the dynamics between various market participants and guide them towards a much more “tolerant” perception of the principle, encouraging them to develop their strategies more openly and to participate in a fruitful dialogue instead of purely rejecting each other’s alternative positions.

## 4.3 The introduction of soft monitoring powers

### 4.3.1 Current monitoring trends

As previously mentioned, listed companies – contrary to institutional shareholders and proxy advisors – are required to follow the principle based on the provisions of Directive 2006/46/EC. The EC consequently investigated whether formal monitoring powers should be given to competent national authorities in order to ensure full respect with the “comply or explain” principle (Commission, 2011b). From the consultation process, it became clear that the majority of respondents were openly opposed to monitoring bodies assuming an active role in controlling disclosed information (Commission, 2011c, 18). The main argument against such a scenario was that the chance of convincing all involved parties to engage with each other in a more open way and understand their respective strategies and priorities would be lost once and for all, since attention would be taken away from the relationship between market participants and would be exclusively focused on the relationship between information providers and the national monitoring bodies.<sup>53</sup>

Undoubtedly, this opinion is not exempt from criticism because it could be also asserted that the intervention of a monitoring process would add a third party, namely a certifier, as is the case in the broad area of financial reporting. Nevertheless, it should be borne in mind that the introduction of a “certifier” in these kinds of statements, associated with corporate governance and stewardship issues, is much less likely to play a key role than in the case of financial reporting. This is due to the fact that it is much more complicated for a monitoring body to control prospective/subjective information, which is inevitably and quintessentially the majority of information related to corporate governance issues. Moreover, a certifier would be subject to manipulation from companies since, after an eventual “monitoring meeting/decision” that would certify their “compliant” status, companies could use it as a legitimate excuse not to engage further in corporate governance issues with shareholders and stakeholders. This would trigger the additional risk of a

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<sup>53</sup> See, for example, the very interesting comments provided by the European Company Law Experts (2011, p. 20). See also Keay (2014, p. 298).



lack of engagement, thus perpetuating the communication gap between various parties. Although such a scenario cannot and should not be completely ruled out in the future, it seems much more realistic to clarify the expectations that interested parties should have from a formal monitoring body and the dissociation of a possible “compliance certification” to the benefit of a company, whose reporting quality has been questioned, from its reluctance to engage with other market participants.

As the current regulatory framework stands, national authorities do not perform any kind of supervisory function in the review of corporate governance statements, with very few exceptions. For example, in the Netherlands, a formal monitoring Committee (*Monitoring Commissie Corporate Governance Code*) was established in 2009. Its role is, amongst other things, to monitor compliance with the corporate governance code and to examine the explanations provided by companies when they do not comply with its provisions.<sup>54</sup> The Committee also writes directly to companies in the case of unsatisfactory explanations and asks them whether they would like to provide an explanation about deviation from the provisions of the Code. Although this effort is highly appreciated and clearly shows the advantages of a soft monitoring framework, we must bear in mind that the Committee has not to date named, positively or negatively, any company that has been subject to this direct contact, precisely to preserve the confidentiality and ensure the efficiency of the process. Moreover, the Committee ensures the monitoring process on its own without being open to potential complaints by market actors regarding the unsatisfactory quality of the information provided by companies. Therefore, this model could be further enriched in the future with “naming” practices and a more participative approach from market actors who would be able to trigger the Committee’s action, as will be shown later in this paper.

Another more passive trend that has gained a certain amount of popularity is the involvement of national authorities in an overview of corporate governance statements leading to the publication of annual reports whose main purpose is to inform the public on progress achieved in compliance rates and the quality of explanations following the principle.<sup>55</sup> This solution is much more apt to encourage investors to understand the overall function of the code and its respect by companies via the disclosure of information on an annual basis.

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54 (Sanderson et al., 2013, p. 5). It seems that the Dutch Committee is quite successful in striking the right balance in this regard since it keeps on engaging in “dialogue enhancing” activities via the organisation of annual meetings with management board members, supervisory directors and shareholders: for details, see Monitoring Committee (2013, p. 16).

55 See, for example, apart from the FRC in the UK, the French regulator’s (*Autorité des Marchés Financiers*) Annual Reports on corporate governance, [http://www.amf-france.org/affiche\\_plan.asp?IdSec=6&IdRub=174&IdPlan=236&Id\\_Tab=0](http://www.amf-france.org/affiche_plan.asp?IdSec=6&IdRub=174&IdPlan=236&Id_Tab=0) accessed 17 March 2014.

Some other authorities have engaged in a much more active consultation approach, which seems to adopt a pedagogical stance in order to encourage companies to engage in a fruitful dialogue with shareholders and stakeholders. Nevertheless, this last approach does not appear to be fully appreciated by the market, which continues to rely on its flexibility in order not to comply with further guidance.<sup>56</sup>

A recent monitoring trend that emerged in France might influence other EU Member States in finding a delicate – but questionable – compromise between the traditional regulator's neutrality and a slightly interventionist approach with regard to respect of the principle. A private body (The High Committee in charge of monitoring the implementation of the code) (*Haut Comité de suivi de l'application du code*:AFEP-MEDEF, 2013, p. 33) composed of four personalities with recognised experience from international groups and three personalities from other sectors (investors, personalities selected for their competence in legal/deontological issues) has assumed the role of monitoring the application of the principles contained in the Afep–Medef corporate governance code as well as proposing updates to the code. The members of the Committee are nominated and appointed by Afep (the French Association of Private Enterprises) and Medef (the French Business Confederation) for a period of 3 years, renewable once, and they also have to declare their directorships in listed companies. The chairman of the Committee is selected amongst the four personalities of the corporate sector and the committee has to produce an activity report on an annual basis.

The committee may receive companies' questions on corporate governance code interpretation issues but also retains the right to contact companies and ask for more information in the absence of meaningful explanation. It should also be noted that companies that choose not to follow the recommendations of the Committee must mention this fact in their annual report/reference document and explain why they have adopted this position (*Haut Comité de suivi de l'application du code*:AFEP-MEDEF, 2013, p. 33). Therefore, companies will be invited to proceed to a second level of informational exposure following again the “comply or explain” principle with regard to the outcome of the contact with the Committee.

Several points of this private monitoring mechanism could be noteworthy and subject to criticism. First of all, introducing a private monitoring body to follow the application of a corporate governance code may, in the long term, weaken the role that competent national authorities play in this field. This is because private forces are trying to create a parallel institutional structure not just in the rulemaking

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<sup>56</sup> See, for example, the FRC's overall regulatory approach and, more specifically, the effort conducted in 2012 and which led to the publication of FRC (2012b). Unfortunately, as previously stated, companies have not followed the guidance provided in this document by the FRC.

process, via the adoption of soft law measures applicable to their sector, but also in the monitoring process, via the introduction of private monitoring bodies that are supposed to control the application of these measures by companies. This new “private hierarchical structure”, whereby market actors make their own rules, base their disclosure choices on the flexibility of the “comply or explain” principle, and control its application themselves, might indeed become problematic in the future, if expanded to other EU Member States, in terms of both legitimacy and efficiency. This phenomenon is inextricably associated with the decades-long trend towards financialisation (Biondi, 2013, p. 391) in our economy and society in general, and it clearly shows that not only the conception of the purpose of corporations and their position in the financial markets, which have become predominant in economies, but also the assumption of control of their practices as well as the assurance of their compliance can be efficiently issued and delivered by the private sector. Nevertheless, the fallacy of this ideological construction is that the private sector is *a priori* unsuitable to exercise such a function due to its dual capacity as “monitoring/monitored” field of activity. Under such a scenario, it is highly unlikely that a neutral monitoring process can be conducted efficiently without any capture by industry interests. Indeed, we must remember that the control function, if any in this area, should remain under the responsibility of national regulators in order to ensure the necessary levels of independence and legitimacy.

Secondly, allowing a more institutionalised dialogue between companies and the Committee, regardless of which party decides to initiate the contact, excludes *a priori* all other market participants from being allowed to contact the Committee and eventually complain about the deficiency of the information disclosed. The current framework therefore restricts the field of application of this mechanism and might risk creating a “one-to-one” conception of dialogue between companies and the Committee, while excluding a much more holistic approach for the Committee’s openness with the public.

Thirdly, under this framework, companies are required to indicate in their annual report/reference document whether they have followed the recommendations of the Committee and, if not, to explain the reasons they have decided not to do so. There seems to be a twofold problem in this requirement: on the one hand, it is rather useless for investors to be informed about the outcome of the contact with the Committee upon disclosure of the annual report/reference document since this disclosure might occur a long time after the actual meeting took place. In other words, it would be preferable to require companies or the Committee to disclose the outcome of this meeting to the market immediately so that investors are informed in due time. On the other hand, requiring companies to follow the “comply or explain” framework in order to justify possible deviations from the Committee’s recommendations, risks adding further interpretation

problems to the poor quality of their explanations or a lack of compliance in general. This is particularly true since companies contacted by the Committee for not having sufficiently respected the “comply or explain” framework in the first place are much less likely to respect it in a satisfactory way if they decide that they want to deviate from the Committee’s recommendations. Therefore, the flexibility offered during the “post-Committee” phase is not of great help in making sure that companies disclose at least *a posteriori* more meaningful information to the Committee and the market.

As previously mentioned, all these efforts are positive signs of a constantly-changing perception of monitoring, but the persisting shortfalls of the principle should continue to prompt further reflection on a regulatory model slightly different from the rigidity of an official supervisory mechanism (the Netherlands) or the questionable efficiency of a private Committee (France) and will, in a holistic approach, encourage all parties involved to disclose information in a “culturally tolerant” but institutionalised environment.

#### 4.3.2 The introduction of Review Panels

##### 4.3.2.1 An “institutionalised dialogue” spectrum

The advantages of a softer monitoring process, compared to a stringent monitoring approach by national competent authorities, are more suitable to all the above-mentioned challenges, especially taking into consideration the fact that, to date, the only binding framework applying the “comply or explain” concept is the one applicable to listed companies. If therefore the desire is to unblock engagement amongst listed companies, institutional investors and proxy advisors – bearing in mind that investors and advisors are currently *encouraged* and not required to sign best practice Principles – a soft monitoring mechanism could be applied by newly established Review Panels forming part of national authorities. Such Review Panels could deal with the entire disclosure chain, namely from the required disclosure arising from Corporate Governance Codes, Stewardship Codes and the Best Practice Principles for Shareholder Voting Research. Although we cannot yet say exactly which regulatory direction will be followed at the EU level in an EU Stewardship Code or the future regulatory framework applicable to proxy advisors,<sup>57</sup> it is essential to start

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<sup>57</sup> Bearing in mind that ESMA has reserved the right to adopt more stringent measures in the future in case GBPP’s efforts do not bring about the desired outcomes. Moreover, it would not be unreasonable nor utopic to see the implementation of a holistic regulatory approach in the future, including in a soft law initiative the entirety of involved parties in the investment chain

preparing the ground at the national level for better interaction between corporate participants. This kind of preparation on enhanced interaction at the national level will therefore be able to enshrine the necessary principles and best practices into the collective market mentality, which will then be much more susceptible to accept any future regulatory framework, acknowledging the advantages of sharing the same transparency level with other interested parties.

In other words, even if regulatory efforts are escalated purely at the EU level, newly established Review Panels can legitimately provide market participants with guidance at the national level and offer a more formal “dialogue spectrum” in case they are notified by a party that considers the information provided to be unsatisfactory.<sup>58</sup>

#### 4.3.2.2 A clear and delineated authority

For the Review Panel’s activity to be efficient and legitimate, its composition and the spectrum of its authority must be clearly identified and delineated.

The composition of the Panel should be as diverse as possible in order to gain immediate acceptance by all market participants as well as to spark interest in participating in its activities. Company directors (executive and non-executive), retail and institutional investors, proxy advisors, as well as investment consultants should be eligible to be elected members of the Panel, along with the employees of the national competent authority, for a maximum period of 3 years. Membership should also be open to other stakeholder groups (unions, customer representatives and others) under the condition that they have developed considerable experience in interacting with market participants and promoting a majority of sustainable investment projects. The “considerable experience” criterion would further strengthen the useful character of the discussions taking place in this framework as well as the quality of the dialogue developed in these discussions. The members’ mandate would not be renewable to avoid increased familiarity with recurrent cases and, more generally, to maintain the merits of rotation in terms of independence and diversity of Panel composition, allowing more representatives from the same sector a chance to serve on the Panel.

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(e.g. including investment consultants, etc.) sharing the same exposure via the adoption of similar disclosure obligations.

<sup>58</sup> This proposal was initially advanced in one of our previous studies but it had a narrower focus since it was exclusively dedicated to the “comply or explain” principle in corporate governance statements: Sergakis (2013).

The eligibility criteria for members should be their considerable experience in their professional activities or substantial proof of their beneficial contribution to establishing better communication with other market participants. The second eligibility criterion could, for example, apply to an asset owner or manager who has proven to be innovative not just in financial performance terms but in creating and maintaining useful communication methods with concrete outcomes, while conducting dialogue with investee companies or proxy advisors. This criterion should thus allow more junior, but active and innovative, professionals to gain additional recognition in their field by participating in the Panel's activities. More generally, creating a diverse composition for the Panel should motivate market participants to be increasingly interested in its activities.

With regard to the spectrum of the Panel's authority, the focus should primarily be on three areas that have by now become, or are increasingly becoming, commonly discussed in disclosure-related debates. These areas are the existence of conflicts of interest, the methodologies adopted in the exercise of professional activities, and the interaction with other market participants and the public. Although more activities could fall within the Panel's remit in the future, it is our belief that, at least for an initial 5-year period, the scope of the claims should be primarily restricted to these three broad areas. The reason for this preference is due to the inevitably diverse rate of progression at the national level with regard to the development of a dialogue and the sophistication rate of national authorities, as well as cultural and social components that may affect the efficiency of the whole process as well as the participation rate in the Panel's activities, both in terms of the frequency of the claims raised and the level of cooperation by the invited party. Moreover, such an initial authority spectrum would match up more harmoniously with the current national and EU regulatory efforts that tend to focus increasingly on these three areas. It would then remain to be seen whether the Panels would eventually converge in the way they would exercise their activities and interact with market participants for such an authority to be enlarged and to include any corporate governance-related matters in the future. This would also allow these three areas to receive more attention and start becoming more accessible to market participants both in terms of their management and their common understanding.

We must also bear in mind that, dealing with a variety of claims and aiming to avoid any potential abuse of its role or instrumentalisation by the parties, the Panel should not be in a position to interfere with purely contractual matters that normally provide a clear framework for the parties' relationship and would not necessitate the development of a dialogue under its guidance.

With regard to potential cases being launched, a party asking for the Panel’s intervention could be an investor complaining about the quality of the information disclosed by a listed company, an institutional investor or even a proxy advisor. Other configurations would also be possible. For example, a listed company could complain about a proxy advisory firm that avoids engagement and then mechanically rejects its corporate resolutions without analysing them in-depth or seeking contact with the company. Therefore, potentially all market participants could be interested in considering the Panel’s intervention since they would all draw benefits from such an initiative and they would all seek a better resolution of their communication gap with other parties.

It would also be necessary to define clear criteria for a Review Panel to be able to allow a request to be put forward and trigger a more active dialogue with the other party. Generally speaking, these criteria could be a detailed explanation of the disclosure-related issue, as well as the implications of the supposed informational deficiency for the claimant party’s affairs. Moreover, the claimant party should provide proof that communication had already been sought, as well as a reasonable explanation as to why the party considers that the outcome of this initiative did not prove fruitful, namely in the case that the party concerned did not cooperate or its corporation did not meet the expectations of the claimant party.

Provided that the request for further examination is well argued and sound, the Review Panel would be in a position to invite the party concerned to attend a meeting for further discussion of the subject, which could entail failure to update the “compliance” statement or the disclosure of perfunctory “non-compliance” explanations. Confidential information should also be protected in this framework, and the relevant rules applicable to the Panel’s functioning should clearly allow parties not to disclose any information for which they have a legitimate interest to maintain confidentiality. Corporate secrecy needs to be included for some delicate matters that, although they may be able to trigger a more fruitful dialogue, may compromise the position of one of the parties involved and have negative repercussions on a larger scale.

The invited party would be given the chance to express its views on the disputed matter, present its own version of the alleged facts as presented by the claimant party, and possibly show that steps have been taken to remediate this situation or even improve the informational context in the future. Under this assumption, the Review Panel would be expected to provide guidance on further actions to ensure that improvement will occur. Guidance should remain always neutral and should focus on general recommendations that could correspond to already existing guidance notes of various soft law texts currently applicable at the national level.



However, if the party does not wish to attend the meeting or attends but without showing a real willingness to cooperate and improve its practices, the Review Panel would have the right to publish a statement summarising the position adopted by this party or outcomes of the meeting. Reputational sanctions and “name and shame” practices would therefore apply in this framework, anticipating that other market participants would evaluate the outcome of this procedure. The Review Panel would therefore remain completely neutral on the persuasiveness of the arguments presented by the party and would only make public its guidance, the dialogue that took place, and the overall outcome of the procedure. Therefore, even if a party considers itself to have formally satisfied the recommendations of the Review Panel, it will not be in a position to hide behind any regulatory approval and ignore similar complaints that may arise in the future.

Maintaining the Panel’s neutrality is the key to the success of such a proposed monitoring mechanism, since the Panel will only offer the chance to the concerned parties to express their views and explain their respective arguments further. The Panel will provide the necessary guidance to ensure that the context of the regulatory tool (Corporate Governance Code, Stewardship Code, Best Practice Principles for Shareholder Voting Research) is respected given the individual circumstances of the examined case.

We thus believe that the introduction of such an “institutionalised dialogue spectrum” will transmit the message to the market that the existence of a Review Panel ensuring transparency over complaints about the quality of information provided is widely applicable and therefore may have the potential to encourage market actors to cooperate further with the Panel and have a chance to justify their positions. The absence of legal sanctions will preserve the incentive for market actors to be more open and will make the Panel seem less intimidating.

This proposal is not exempt criticism, especially with regard to the costs involved in the running of the Panel, both in terms of time spent for the examination of all possible complaints and in terms of human resources needed to staff it adequately. Undoubtedly, the related costs will be an important factor but may be well justified depending on the balance between different priorities and prerogatives for the future investment landscape. In other words, if the main purpose of financial regulation is to intervene more actively and impose more stringent requirements on all market actors, this will inevitably be a well justified regulatory objective and may even be a case in the not so distant future. However, as previously mentioned, before that decision can be made at an institutional level, regulators need to ask a much more fundamental question: is soft law still a viable solution for capital markets and behavioural change amongst participants?

If the answer to this question is yes, then the undoubted benefits of regulatory flexibility and soft law rulemaking should not be immediately eliminated. The



reason for this argument is that, as shown in this paper, the main problem with soft law rules and the “comply or explain” principle is not their inability to function as a convincing regulatory tool. It is rather the exploitation of regulatory flexibility by regulatees and the mechanistic use by information recipients that makes the principle less convincing. Thus, current regulatory initiatives should focus instead on how the distorted perception of the “comply or explain” principle can be remedied in order to restore its efficiency. Abandoning the principle or integrating it into a hard law framework associated with dissuasive legal sanctions will inevitably shift the focus from the need for a behavioural change towards the need for sanctioning continued short-term and opaque behaviour.<sup>59</sup> Although this scenario cannot – and probably should not – be avoided in the future, it is in the best interests of regulators and markets to make sure to exploit the unique opportunity they have in the wake of the recent financial crisis: give market participants a last chance to engage with each other in an attempt, through legitimate compromise and mutual acceptance, to reach a collective consensus on the future of capital markets and each party’s role therein.

As previously mentioned, the flexibility of soft law measures has been traditionally, if not conceived, at least instrumentalised to function as a convincing excuse for the maintenance and expansion of a financialised corporate governance framework. It is therefore legitimate to question this instrumentalisation and seek new ways to make soft law measures much more efficient by protecting them from attempts to make them a fruitless pedagogical and idealistic exercise between market participants. We firmly believe that the introduction of a soft monitoring framework will give the debate between various participants renewed potential to achieve something concrete instead of ending up being considered another gentle “window-dressing” exercise.

In order for such an initiative to succeed, all parties involved in this dialogue would need to be guided by the Review Panel in terms of what they

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<sup>59</sup> It should be borne in mind that a hard law framework does not necessarily have this persuasive function because it is associated with sanctions and with a rather “reprimanding” connotation when the rule is violated. Inevitably, participants’ actions might change more quickly with hard law because they will try to avoid sanctions but this will not necessarily transform their mentality.

An obvious example is the continuous violation of disclosure obligations from listed companies notwithstanding the presence of a hard law framework in this area. Moreover, other factors need to be taken into consideration, namely enforcement and surveillance, that, if not ensured in an efficient way, will keep on hampering sanctions’ dissuasive force. Although some optimism should be allowed, especially with regard to national competent authorities, who have started raising the quantum of sanctions the past few years, civil remedies and criminal sanctions still necessitate further improvement and action both at EU and at national levels.

can expect from its presence, its contribution to the debate and its level of intervention. They will also need to acknowledge in advance that this soft monitoring framework aims exclusively to provide an “institutionalised framework” for them to interact and try to understand each other’s priorities and positions, while offering some guidance for this dialogue to lead to a better understanding of the situation that triggered the Panel’s intervention. Bearing these two elements in mind, the Panel will then try to provide the necessary educational background to the parties involved and show them that dialogue does not necessarily mean only vulnerable exposure to the rest of the market that can be instrumentalised, but a case that can strengthen their position by presenting a series of convincing arguments in defence of their strategies.

If we take into consideration the fact that mechanisms such as “comply or explain” have not been taken seriously, or even worse have been instrumentalised, by the providers and recipients of the information disclosed, the contribution stemming from the regulatory framework needs to be the preservation of the system and, most importantly, the education of its users, who are ultimately responsible for the efficiency of the mechanism. This type of education can more feasibly occur within the scope of a neutral Review Panel that will continue to deal with various requests and to guide the parties involved in realising the benefits of engagement in each and every occasion for dialogue.

While “education” and “trust” are words that have been traditionally identified with idealistic or utopic goals, we must remind ourselves that capital markets are still composed of individuals who seek profit regardless of their position, responsibilities or power, as well as the possibility or willingness for interaction with other participants. If the market has become so fragmented and interaction practically impossible, lawmakers and regulators must find ways to change the dynamics of an extremely complicated system and to place some common principles at the heart of the investment community. These principles should be the common perception of the primary purpose of capital markets, corporations and investment. Although these principles continue to be hotly debated and a common solution to the satisfaction of all parties involved cannot easily be reached, the purpose of education will be to reorient their short-term goals for profit and show them that if they work collectively they may have a chance to achieve the same profit under a long-term perspective without compromising their position, while preserving in the meantime the stability of the system since speculation would not be their unique goal in the market.

This does not mean that speculation would disappear from capital markets since it will necessarily take years to reach a common understanding of why and how all parties try to generate profit. But the educational foundations of the regulatory framework would mean that people who participate in the market

need to understand the overall ramifications of their actions not only for other participants but for the viability of markets themselves, on which they will have to keep relying in order to achieve their purposes.

In order for such understanding to take place and for parties to be able to distinguish when they need to adopt short-term or long-term strategies, awareness of their counterparties' position will be crucial. This will be better achieved under a generalised and regular dialogue framework, wherein such a need to communicate further and launch an additional level of dialogue can be triggered by one of these parties by contacting the Review Panel. Therefore, the proposed soft monitoring framework does have a role to play.

## 5 Conclusion

This paper has endeavoured to show the proliferation of the “comply or explain” principle as well as its current perception by regulatees and users. This ideological “deconstruction” of the principle showed the need for its “reconstruction” via enhanced interaction between market actors and the development of a more tolerant culture with regard to compliance statements. To overcome the ramifications of the financial crisis, some of the distinctive features of which were linked to a failure of modern investment culture, a better understanding of how market actors perceive each other's informational exposure is vital. This understanding, as we partially attempted in this paper, is aimed at facilitating the adoption of efficient measures that will not just encourage but actually ensure that market participants respect a common set of principles about sharing the same transparency prerogative and responsibilities arising from their activities in the investment chain. It comes as a natural conclusion that for such objective to be achieved, regulators must find ways not only to sanction illegal or “non-compliant” behaviour but, most importantly and as a preventive measure, to facilitate communication, engagement and constant interaction.

Acknowledging the need to provide a more pedagogical and educational framework for complaints can be heard and discussed, Review Panels should be in a position to offer this framework and contribute, gradually but steadily, to this educational purpose. As all market actors are now expected to adopt a long-term investment culture, the associated costs with the function of these Panels should also be seen as a long-term investment for the shaping of a sound regulatory culture that seeks not only to sanction regulatees but also to guide them towards adopting sound investment strategies. The road to adopting the preferred delivery framework will undoubtedly be a very long and arduous one, and the above-mentioned proposal is by no means the ideal solution to achieve

the desired outcomes. Nevertheless, it could be a realistically achievable initiative that could be legitimately pursued at the national level. Most importantly, it might serve as a last resort mechanism for the legitimisation of the “comply or explain” principle before the latter radically loses its flexible characteristics and is transformed into a much more stringent approach or simply abandoned. Hard law can possibly be legitimately seen as a last resort solution, at least for the time being, depending on whether regulators still believe that there is room for behavioural change and incentivising market actors to adopt a long-term investment culture. This will inevitably be the most challenging task in the years to come, not only for the regulatory reactivity but, most importantly, for market participants to show that they are willing to participate in a new, less financialised and more holistic investment environment.

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